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Combatting Fraud In The Individual Surety Bond Program

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## COMBATTING FRAUD IN THE INDIVIDUAL SURETY BOND PROGRAM

### I. INTRODUCTION

Fraud has been no stranger to federal procurement both historically<sup>1</sup> and in modern times.<sup>2</sup> One slice of the current procurement fraud pie involves the federal government's individual surety bond program. This program was designed to increase opportunities for small businesses to compete for federal contracts. The program seeks to achieve this goal by providing a more accessible and less expensive alternative to corporate surety bonds, which are provided by contractors to satisfy the demands of the Miller Act. Under this program an

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<sup>1</sup> See e.g. United States v. Mowry, 14 S.Ct. 1213 (1869) (payment suspended to contractor who built railroad cars for Union forces after allegations of fraud); see also Lieutenant Colonel Douglas P. DeMoss, Procurement During The Civil War And Its Legacy For The Modern Commander, Army Law., March 1997, at 10 (During the Civil War "the procurement of inferior or unsupportable equipment, as well as overcharging, corruption, and fraud, seriously tainted early war efforts . . . ."); William P. Barr, Forward, Seventh Survey of White Collar Crime, 29 Amer. Crim. L. Rev. 169, 171 (1992) (defective arms during Revolutionary War); Howard W. Cox, FASA And False Certifications: Procurement Fraud On The Information Superhighway, 25 Pub. Cont. L. J. 1, 10 (1995) ("For more than 200 years, the Federal Government has conducted a seemingly endless war against fraud by its contractors.").

<sup>2</sup> See e.g. United States v. Lawrence, 122 F.3d 1064 (4th Cir. 1997) (theft of competitor's proprietary bid information); United States v. Hatfield, 108 F.3d 67 (4th Cir. 1997) (contractor indicted for false certifications accompanying bid and for false certifications for payment); United States v. Glymph, 96 F.3d 722 (4th Cir. 1996) (supplying DoD with nonconforming parts); United States v. Apex Roofing Of Tallahassee, 49 F.3d 1509 (11th Cir. 1995) (false certifications submitted with progress payment requests); United States v. Monaco, 23 F.3d 793 (3rd Cir. 1994) (inflated progress payment submittals); see generally Andy Pasztor, When The Pentagon Was For Sale (1995) (defense industry corruption during Reagan Administration).

individual can post certain collateral, such as land, in support of a surety bond for a federal contract. Unfortunately, many of the safeguards that make corporate surety bonds more expensive and less available to financially insecure contractors are missing from the individual surety bond program. The reduced number of safeguards, coupled with various systemic shortcomings, have produced a nidus for fraud.

Incidents of criminality involving individual sureties reached almost epidemic proportions in the late 1980s, generating a nationwide crackdown on individual surety bond fraud involving federal construction contracts. As of July 1989, the General Accounting Office (GAO) identified 95 active investigations of individual sureties by eleven separate federal agencies.<sup>3</sup> Eventually, federal prosecutors brought indictments and achieved convictions in Arizona,<sup>4</sup> Maryland,<sup>5</sup> Tennessee,<sup>6</sup> and California.<sup>7</sup>

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<sup>3</sup> GAO Fact Sheet for Congressional Requester, Individual Sureties Used for Support of Federal Construction Contract Bonds (GAO/RCED-90-28FS), Oct. 1989, at 14-15 [hereinafter GAO Fact Sheet]. The lion's share of these investigations (45) were being pursued by the Army's Criminal Investigation Command (CID). Id. at 15.

<sup>4</sup> Victor Merina, Probe Sought of Bonding Firm in Pack Defaults, Los Angeles Times, Metro, at 1 (six indictments); see also United States v. Joseph, 921 F.2d 282 (9th Cir. 1990) (Table), 1990 WL 212677, cert. denied, 499 U.S. 929 (1991) (4 convictions).

<sup>5</sup> J.B. Pierpont and Darrell Preston, Feds Launch Nationwide Probe of Fraud In Surety Bond Field, Wash. Bus. J., April 29, 1991, at 6 (five indicted for providing fraudulent bonds for a housing construction contract at the Army's Aberdeen Proving Grounds.). Most of those indicted were based in the Dallas, Texas area. Darrell Preston and J.B. Pierpont, Local Brokers Indicted In Bond Probe, Dallas Bus. J., April 19, 1991, at 1; see also United States v. West, 2 F.3d 66 (4th Cir. 1993)

Characterized by one Navy attorney involved with the fraud investigations as "one of the biggest areas of [contracting] fraud going," federal investigators estimated losses to the government and small business at millions of dollars annually.<sup>8</sup> A single Maryland surety bond broker operating from 1985 to 1988 received \$906,985 in fees after supplying performance and payment bonds to eight different federal agencies for 32 construction contracts, valued at \$27.8 million.<sup>9</sup>

Responding to the systemic problems in the program, in 1990 substantial changes were made to the Federal Acquisition Regulation (FAR). Despite these improvements, the program remains susceptible to abuse. Albeit no central informational

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(convictions of two individuals arising from filing of numerous false Affidavit of Individual Surety between 1986-1988).

<sup>6</sup> United States v. Merklinger, 16 F.3d 670, 672 (6th Cir. 1994) (surety signed approximately 100 fraudulent Affidavit of Individual Surety containing inflated asset figures). Indicted and convicted in 1992, the misconduct occurred between 1987 and 1989. Id.

<sup>7</sup> Seth Rosenfeld, 2 Bay Area Men Charged In Scam, San Fran. Exam., Dec. 21, 1993, at A8 ("a company president was sent to prison for running the nation's largest fraudulent construction bond scheme . . . .")

<sup>8</sup> John R. Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967; see also John R. Emshwiller, Firms Hurt In U.S. Contracting Scandal May Get Help, Wall St. J., May 31, 1990, at B2 ("federal investigators estimate such sureties have cheated small businesses out of tens of millions of dollars in the scandal.").

<sup>9</sup> Broker Enters Guilty Plea Over Surety Bond Fraud, Wall St. J., Aug. 3, 1992, 1992 WL-WSJ 642409.

repository exists,<sup>10</sup> reports of criminal investigations, indictments and convictions indicate that the individual surety bond program remains a ripe target for fraud.<sup>11</sup> Recently, a Phoenix-based multi-agency effort netted eight convictions of individuals and companies associated with fraudulent individual surety bond activity.<sup>12</sup> In related proceedings, the Army

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<sup>10</sup> Telephone interview with Johnny Kahn, Inspector General's Office, Small Business Administration, April 7, 1998 (does not compile that information); Telephone interview with Phil McGuire, Director, U.S. Army Crime Records Center, February 25, 1998 (does not track that specific offense); Telephone interview with Captain Theresa Blackwell, Air Force Office of Special Investigations, Jan. 12, 1998 (does not collect that data).

<sup>11</sup> United States v. Leahy, 82 F.3d 624 (5th Cir. 1996) (false sureties provided for Veterans Administration roofing contract); United States v. Simpson, CR 98-263-PHX (D. Az., filed May 5, 1998) (eighteen count indictment for making false appraisals in support of individual surety bonds on federal contracts); Douglas McLeod, Backed By Bogus Assets, Bus. Ins., Jan. 8, 1996, at 6 ("Three men are facing criminal charges in an alleged scheme to sell more than \$10 million in bogus surety bonds to private contractors doing work for the federal government."); Californian Pleads Guilty In Surety Bond Fraud Case, Inside DOT & Transp. Wk., April 15, 1994, 1994 WL 2696407 (pled guilty to providing false individual surety bond for Coast Guard construction project.)

<sup>12</sup> United States v. Hunt, No. CR-95-299-1-PHX-RCB (D. Az. Sentenced April 8, 1996) (jury verdict), affirmed, No. 96-10181 (9th Cir. Mar. 14), cert. denied, 118 S.Ct. 130 (1997); United States v. Turner, No. CR-96-130-PHX-SMM (D. Az., filed Feb. 16, 1997); United States v. Novick, No. CR-97-61-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997); United States v. Wisse, CR-96-379-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997); United States v. MGA Bonding And Assurance Inc., No. CR-97-61-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997); United States v. Ponikvar, CR-96-521-PHX-MS (D. Az., filed Nov. 27, 1996); United States v. DeSanti, No. CR-96-53-01-PHX-PGR (D. Az. Plea Agreement filed Jun. 29, 1996); United States v. Imperial Surety Service, No. CR-96-53-02-PHX-PGR (D. Az. Plea Agreement filed Jun. 29, 1996).



Procurement Fraud Division proposed sixty eight businesses and individuals for debarment; fifty six were actually debarred.<sup>13</sup>

This thesis will review the purpose and development of the Miller Act and the individual surety bond program, examine FAR bonding requirements and highlight various programmatic shortcomings, particularly those failings that make the program particularly susceptible to fraud. The thesis will suggest changes to the FAR and other federal enforcement mechanisms to reduce the program's vulnerability to abuse. Finally, the work will discuss surety bond fraud specific sentencing issues under the federal sentencing guidelines, drawing guidance from the Contract Disputes Act of 1978 when appropriate.

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<sup>13</sup> Telephone interview with Zetta Proffitt, Army Procurement Fraud Division, February 25, 1998.

## II. THE MILLER ACT AND SURETY BONDS

### A. Pre-Miller Act

The legal concept of suretyship has existed since at least biblical times.<sup>14</sup> Further, references to suretyship is found in the Code of Hammurabi and the English Magna Carta.<sup>15</sup> Construction contract surety bonds supported procurement during the Roman Empire. In 106 B.C., a Roman gateway construction project required "that 'whoever shall be awarded the contract shall furnish bondsmen secured by real estate to the satisfaction of the magistrates.'"<sup>16</sup>

Surety bonds have enjoyed a long history in our country. To illustrate, in Haldane v. United States,<sup>17</sup> the United States required a bid guarantee and performance bond for an 1890 hay and straw delivery contract for Fort Riley, Kansas. Similarly, in United States v. American Bonding & Trust Co.,<sup>18</sup> the court makes

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<sup>14</sup> The Surety Association of America, Contract Bonds: The Unseen Services Of A Surety 3 (1996) [hereinafter "Contract Bonds"]. In Genesis, the Bible lists Judah as a personal or individual surety for his brother; and in Proverbs Solomon "warned that 'he that is surety for a stranger shall smart for it.'" Id. (citing Genesis 43:9; Proverbs 11:15).

<sup>15</sup> Id.

<sup>16</sup> Richard S. Wisner and James A. Knox, Jr., The ABC's Of Contractors' Surety Bonds, 82 Ill. B.J. 244 (May 1994) (citing J. Harry Cross, Suretyship Is Not Insurance, 30 Ins. Counsel J. 235 (1963)).

<sup>17</sup> 69 F. 819 (8th Cir. 1895) (discussed in Anthony M. Helm, Construction Contract Bonds--A Primer, Army Law., Oct. 1990, at 21-2).

<sup>18</sup> 89 F. 921 (C.C.D. Md.), affirmed, 89 F. 925 (4th Cir. 1898).

mention of government required performance and payment bonds for the construction of a hospital at Fort Meyer, Virginia.

Even individual surety bonds have been no stranger to federal contracts.<sup>19</sup> In Day v. United States,<sup>20</sup> three individuals acted as sureties for a performance bond, furnished for a contract to provide horses to the United States cavalry. When Day delivered nonconforming horses to the cavalry, the United States rejected the horses and purchased replacements on the open market.<sup>21</sup> Upon completion of its equine purchases, the United States sued the individual sureties seeking the difference between the original contract price and the amount the United States actually paid for their mounts.<sup>22</sup>

As a predecessor to the Miller Act, in 1894 Congress passed "An Act For the protection of persons furnishing materials and labor for the construction of public works."<sup>23</sup> Commonly known as the Heard Act,<sup>24</sup> the statute was the first federal bonding statute.<sup>25</sup> The Heard Act required the execution of a penal bond,

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<sup>19</sup> See e.g. Brown v. United States, 152 F. 964 (C.C.A. 2d Cir. 1907) (individual sureties on bid bond).

<sup>20</sup> 87 F. 125 (8th Cir. 1898).

<sup>21</sup> Id.

<sup>22</sup> Id.

<sup>23</sup> Ch. 280, 28 Stat. 278 (1894).

<sup>24</sup> Bernard L. Balkin, Recovery of Damages For Delay Against Sureties On Public Works Bonds, 20 Forum 640, 641 (1985).

<sup>25</sup> Ralph C. Nash, Jr. and John Cibinic, Jr., II Federal Procurement Law 1763 (1980).

"with good and sufficient sureties," by any person entering into a formal contract with the United States for construction of public buildings or the completion of any public works.<sup>26</sup> Additionally, the Act required contractors to promptly pay all laborers and suppliers of material.<sup>27</sup> Unpaid materialmen and laborers were authorized to bring suit against the contractor and surety.<sup>28</sup>

However, various court interpretations of the Heard Act undercut protections of federal interests that the legislation was, at least in theory, supposed to provide.<sup>29</sup> Subcontractors were permitted to sue on the bond prior to contract completion and the bond's coverage was reduced by the amount of the judgment.<sup>30</sup> Government claims were placed on an equal basis with the claims of unpaid laborers and materialmen.<sup>31</sup>

In 1905, Congress amended the Heard Act, granting priority to the United States for any claim on the bond.<sup>32</sup> Unpaid

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<sup>26</sup> Ch. 280, 28 Stat. 278 (1894).

<sup>27</sup> Ch. 280, 28 Stat. 278 (1894).

<sup>28</sup> Ch. 280, 28 Stat. 278 (1894); see also Nash & Cibinic, supra note 25, at 1763.

<sup>29</sup> Austin T. Stickells, Bonds Of Contractors On Federal Public Works - The Miller Act, 36 B.U.L.Rev. 499, 501 (1956).

<sup>30</sup> Id. at 501-502.

<sup>31</sup> Id. at 502.

<sup>32</sup> Stickells, supra note 29, at 502 ("the claim of the United States would be prior, and that the government must be fully satisfied before others could proceed on the bond . . . ."); Balkin, supra note 24, at 641 ("in the event of the contractor's failure in the performance of his contract the

laborers and materialmen enjoyed the right to intervene in any action brought by the United States or, if the government failed to sue, they could initiate their own action.<sup>33</sup> However, claimants were required to wait six months to see if the United States would bring suit, sue themselves within one year of final performance and settlement of the contract, and join in a single legal action.<sup>34</sup>

## **B. Miller Act**

Appearing in 1935, the Miller Act, 40 U.S.C. §§ 270a-270f, responded to the perceived shortcomings of the Heard Act. Subcontractors had complained to Congress that the Heard Act's procedural requirements delayed their ability to bring suit on the bond, delaying their claims from six months to four years.<sup>35</sup> In response, Congress required contractors to post both performance and payment bonds on contracts worth more than \$2,000, and permitted laborers and materialmen to sue on the payment bond ninety days after the final performance of work or delivery of material, respectively.<sup>36</sup>

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United States would have priority in its claim against the bond . . . .")

<sup>33</sup> Stickells, supra note 29, at 502; Balkin, supra note 24, at 641.

<sup>34</sup> Stickells, supra note 29, at 502.

<sup>35</sup> Id. at 503; Balkin supra note 24, at 644.

<sup>36</sup> Balkin, supra note 24, at 644 (citing H.R. Rep. 1263, 74th Cong., 1st Sess. 3 (1935)). Under the Heard Act only a

The current version of the Miller Act requires contractors to provide performance and payment bonds to the government as a condition precedent to the award of "any contract for the construction, alteration, or repair of any public building or public work of the United States . . . ." <sup>37</sup> In 1994 the Federal Acquisition Streamlining Act (FASA) eliminated the Miller Act's surety bond requirements for contracts under the simplified acquisition threshold of \$100,000. <sup>38</sup> Further, for contracts between \$25,000 and \$100,000 FASA requires the contracting officer to use two or more of the following: (1) a payment bond, (2) an irrevocable letter of credit, (3) an escrow arrangement, (4) certificates of deposit, (5) United States bonds or notes, or (6) some form of "certified or cashier's check, bank draft, Post Office money order, or currency . . . ." <sup>39</sup>

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performance bond was required. Stickells, supra note 29, at 502; Eugene F. Brady, Bonds On Federal Government Construction Contracts, 46 N.Y. Univ. L. Rev. 262, n.1 (1971) (Under the Heard Act, "the performance and payment bonds were written as one bond.").

<sup>37</sup> 40 U.S.C.A. § 270a(a) (West Supp. 1997). The implementing regulations for these statutory bond requirements are contained in Part 28 of the Federal Acquisition Regulations (FAR). 48 C.F.R. Part 28 (1998).

<sup>38</sup> Daniel J. Donohue and George W. Thomas, Surety Bond Basics, Construction Briefings No. 96-3, at 3 (Feb. 1996); see also 40 U.S.C. § 270d-1 (West Supp. 1998); accord FAR 28.102-1(a).

<sup>39</sup> FAR 28.102-1(b)(1), 204-1, 204-2; see also Donohue and Thomas, supra note 38, at 3 ("directed agencies to develop alternatives to payment and performance bonds for contracts between \$25,000 and \$100,000.")

Although the Miller Act does not define the terms "public building or public works", the United States Supreme Court, in United States ex rel. Noland Co. v. Irwin,<sup>40</sup> defined the term "public works" broadly to include "'any projects of the character heretofore constructed or carried on either directly by public authority or with public aid to serve the interests of the general public.'"<sup>41</sup> A project may still be considered a public works "even if the government has no title to the buildings, improvements, or land on which they are situated."<sup>42</sup>

Notwithstanding this broad definition of a public works, subsequent judicial decisions have predicated Miller Act applicability upon the work in question being one "contracted for by the United States or by an agency of the United States or a person acting as an agent of the United States."<sup>43</sup> Unless this threshold requirement is satisfied, the Miller Act does not apply "even when the construction projects themselves have been carried

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<sup>40</sup> 316 U.S. 23 (1942).

<sup>41</sup> Id. at 28 (citation omitted); see also United States ex rel. Vealey Et. Al. v. Suffolk Const. Co., 1996 WL 391875 (S.D.N.Y.). The definition of public works under the Miller Act is broader than that found under the Heard Act. Noland, 316 U.S. at 29.

<sup>42</sup> United States ex rel. General Elec. Supp. Co. v. United States Fidelity & Guaranty Co., 11 F.3d 577, 580 (6th Cir. 1993) (citing Noland, 316 U.S. at 29).

<sup>43</sup> United States ex rel. Tri-State Road Boring, Inc. v. United States Fidelity & Guaranty Co., 959 F. Supp. 345, 347 (E.D. La. 1996); see also United States ex rel. Vealey Et. Al. v. Suffolk Const. Co., 1996 WL 391874, \*3 (S.D.N.Y.); United States v. Mattingly Bridge Co., 344 F. Supp. 459, 461 (W.D. Ky. 1972).

out for public purposes or funded by public revenues."<sup>44</sup> Additionally, the Miller Act applies only to bonds furnished to the United States.<sup>45</sup> The Act does not provide subject matter jurisdiction to a second tier subcontractor suing on a payment bond that a first tier subcontractor provided to the prime contractor.<sup>46</sup>

### C. Surety Bonds

A surety bond is a contract between three parties: the principal (contractor), surety, and the obligee (government).<sup>47</sup> Generally, the bond must be in writing and is designed to ensure the contractor fulfills its obligations to the government.<sup>48</sup> If the contractor defaults or is otherwise unable to meet its obligations, the bond assures payment of the government's associated losses.<sup>49</sup> A surety bond is similar to an insurance

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<sup>44</sup> Suffolk Const. Co., 1996 WL 391874, at \*3.

<sup>45</sup> United States ex rel. Tri-State Road Boring, Inc. v. United States Fidelity & Guaranty Co., 959 F. Supp. 345, 347 (E.D. La. 1996); see United States ex rel. Ehmcke Sheet Metal v. Wausau Insur. Co., 755 F. Supp. 906, 08 (E.D. Cal. 1991) ("By statute, the surety's payment bond must run to the benefit of the United States . . .").

<sup>46</sup> Tri-State Road Boring, 959 F. Supp. at 347.

<sup>47</sup> Fidelity And Surety Law Committee, Tort and Insurance Practice Section, American Bar Association, Payment Bond Manual 1 (1991) [hereinafter "Payment Bond Manual"]; FAR 28.001. A principal may not act as its own surety on a government contract. Glenn's Heating, ASBCA No. 32723, 87-1 BCA ¶ 19,355.

<sup>48</sup> FAR 28.001.

<sup>49</sup> FAR 28.001.



policy in terms of the protection it provides. However, unlike an insurance policy, corporate sureties require the principal to indemnify the surety.

### 1. Bid Guarantee/Bond

Bid guarantees, such as bid bonds, are not mandated by the Miller Act; rather, they are required by the Federal Acquisition Regulation (FAR).<sup>50</sup> A Contracting Officer may only require a bid guarantee when a performance bond, or both performance and payment bonds, is mandated.<sup>51</sup> The bid guarantee requirement may be waived if the chief of the contracting office determines that such a requirement is not in the government's "best interest" for a particular procurement, such as "overseas construction, emergency acquisitions [or] sole-source contracts."<sup>52</sup>

The bid guarantee serves two primary functions. First, it assures that the bidding contractor will not prematurely withdraw its offer.<sup>53</sup> Known as the firm bid rule, the FAR requires that bidders in a sealed bid procurement agree not to withdraw their offers for a fixed period after bid opening.<sup>54</sup> The government usually requires the offeror to hold its bid open for sixty

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<sup>50</sup> FAR 28.101-1(a).

<sup>51</sup> Id.

<sup>52</sup> FAR 28.101-1(c).

<sup>53</sup> FAR 28.001.

<sup>54</sup> FAR 52.214-16; see also Helm. supra note 17, at 21; cf. FAR 52.228-1(d) ("period specified for acceptance")

days.<sup>55</sup> For construction contracts, the FAR requires a separate bid guarantee and authorizes agencies to posit that only a specific type of bid guarantee - a bid bond - is acceptable.<sup>56</sup>

Second, the bid guarantee assures that the successful bidder will timely execute the contract and submit any required bonds.<sup>57</sup> By requiring a bid guarantee, the government ensures that the offeror will "honor its bid,"<sup>58</sup> and preserves the government's "benefit of its bargain."<sup>59</sup>

If the contractor fails to honor its bid, the contractor and the surety are liable for any additional costs incurred by the government in reprocurring the contract.<sup>60</sup> If another responsible, responsive offeror is available, damages are usually measured by the difference between the dishonored bid and the bid

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<sup>55</sup> FAR 52.214-15; see also Helm, supra note 17, at 21.

<sup>56</sup> FAR 28.101-1(b).

<sup>57</sup> FAR 28.001; see also FAR 52.228-1(d) & (e).

<sup>58</sup> Donohue and Thomas, supra note 38, at 2 ("guarantees . . . the principal will honor its bid and sign all contract documents if awarded the contract.").

<sup>59</sup> Helm, supra note 17, at 21 ("This guarantee also protects the government from losing the benefit of its bargain if the low bidder is unable to, or refuses to, furnish the performance and payment bonds required by the solicitation.").

<sup>60</sup> Donohue and Thomas, supra note 38, at 2; see Helm, supra note 17, at 21 ("Although the offeror still remains liable to the government if it fails to execute the contract, recourse to the surety provides a more certain and expeditious means of recovery."); see Communications by Johnson, B-255478, 94-1 CPD ¶ 163, at 5 ("if a contractor fails to honor its contract in any respect, the bid bond secures a surety's liability for all procurement costs.").

of the next lowest bidder.<sup>61</sup> FAR 52.228-1 specifically provides that any construction contractor, terminated for failing to execute the requisite contractual documents or provide additional bonds, shall be "liable for any cost of acquiring the work that exceeds the amount of its bid . . . ." <sup>62</sup> Other FAR provisions extend this liability to both the contractor and its sureties.<sup>63</sup> The bid bond's penal sum usually limits the surety's liability.<sup>64</sup>

Additionally, if the offeror fails to satisfy the FAR's bid guarantee requirements, the bid is normally rejected.<sup>65</sup> Generally, a bid guarantee may be deemed defective if it fails to satisfy form, quantum or timeliness requirements.<sup>66</sup>

More specifically, in a sealed bid procurement, the failure to furnish a bid bond renders the offer nonresponsive<sup>67</sup> and it

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<sup>61</sup> Donohue and Thomas, supra note 38, at 2; see Associated General Contractors of America and the National Association of Surety Bond Producers, The Basic Bond Book 3 (1980) ("The damages may be actual or the difference between the contractor's low bid and the contract price the owner must pay to the firm to whom he ultimately awards the contract.") [hereinafter "The Basic Bond Book"]. This has been an acceptable measure of damages since at least the turn of the century. See Brown v. United States, 152 F. 964 (C.C.A. 2d Cir. 1907).

<sup>62</sup> FAR 52.228-1(e).

<sup>63</sup> See FAR 52.249-10 (inclusion required by FAR 49.504(c)(1)).

<sup>64</sup> Donohue and Thomas, supra note 38, at 2. "The penal sum of a bid bond is usually 10% to 20% of the bid amount." Id.

<sup>65</sup> FAR 28.101-4(a) (waiver possible in limited circumstances); 52.228-1(a).

<sup>66</sup> FAR 52.228-1(a).

<sup>67</sup> See e.g. Bio-Nomic Serv., B-278341, 97-2 CPD ¶ 173, at 1 ("The contracting officer rejected the low bid as nonresponsive

must be rejected.<sup>68</sup> Similarly, a bid accompanied by a defective bid bond renders the entire bid defective and nonresponsive.<sup>69</sup> Responsiveness is measured at the time of bid opening.<sup>70</sup> To satisfy this requirement, the agency must be able to "determine definitely from the documents submitted with the bid that the bond would be enforceable against the surety should the bidder

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because the bidder failed to provide the required bid bond."); see also Richard J. Bednar Et Al., Construction Contracting 109 (1991) (A bid is rendered nonresponsive by a bidder's failure to submit a required bid bond prior to bid opening."). "Responsiveness concerns whether a bidder has unequivocally offered to provide or perform services in accordance with the solicitation." Cal-City Construction, B-278796, 98-1 CPD ¶ 82, at 2-3. In contrast, responsibility relates to "the bidder's ability to perform. Id. at 3.

<sup>68</sup> See Bio-Nomic Serv., B-278341, 97-2 CPD ¶ 173, at 2; Cf. Brothers Const. Co., B-278042, 97-2 CPD ¶ 135, at 2 ("A bid bond is a material requirement of an IFB with which there must be compliance at the time of bid opening . . . .").

<sup>69</sup> Brothers Const. Co., B-278042, 97-2 CPD ¶ 135, at 2; Ray Ward Const. Co., B-256374, 94-1 CPD ¶ 367, at 2; Communications By Johnson, B-255478, 94-1 CPD ¶ 163, at 5; Emerald Electric, B-212460, 83-2 CPD ¶ 505, at 1-2.

<sup>70</sup> R.P. Richards, B-272430, 96-2 CPD ¶ 138, at 2 ("the acceptability of a bid bond (and responsiveness generally) must be determined from the face of the bid at the time of bid opening."); Morrison Const. Serv., B-266233, 96-1 CPD ¶ 26, at 4 ("The sealed-bid system requires that responsiveness be determined solely on the information available at bid opening."); see also Brothers Const. Co., B-278042, 97-2 CPD ¶ 135, at 2 ("there must be compliance at the time of bid opening . . . ."); Bio-Nomic Serv., B-278341, 97-2 CPD ¶ 173, at 2 ("at the time of bid opening . . . ."); Jay-Brant Gen. Contractors, B-274986, 97-1 CPD ¶ 17, at 4 ("time of bid opening."); Bednar, supra note 67, at 89 ("Responsiveness is determined by reference to the bids when they are opened and not by reference to subsequent changes in a bid.) (citation omitted).

In the event of a problem, an individual surety may request to substitute assets. FAR 28.203-4. However, the contractor may not substitute or add sureties after bid opening. Gene Quigley, B-241565, 91-1 CPD ¶ 182; Electrical Generation Tech., B-235809, 89-2 CPD ¶ 204.

fail to meet its obligations."<sup>71</sup> If the agency cannot make this determination, the bid will be declared nonresponsive and rejected.<sup>72</sup>

Additionally, a bid bond may be proper on its face, and thus responsive, but the sureties may nevertheless be determined to be nonresponsive.<sup>73</sup> A contracting officer may consider the surety's lack of responsibility when determining whether to reject the contractor as nonresponsive.<sup>74</sup> The FAR requires that a contracting officer make an affirmative determination of responsibility before awarding any contract.<sup>75</sup>

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<sup>71</sup> Brothers Const. Co., B-278042, 97-2 CPD ¶ 135, at 2; see also Ray Ward Const. Co., B-256374, 94-1 CPD ¶ 367, at 2; Bednar, supra note 67, at 109 ("In analyzing bond defects the issue is whether the bond is enforceable against the surety despite the defect.").

<sup>72</sup> Ray Ward Const. Co., B-256374, 94-1 CPD ¶ 367, at 2 ("If the agency cannot determine definitely from the documents submitted with the bid that the surety would be bound, the bid is nonresponsive and must be rejected."); cf. Bednar, supra note 67, at 110 ("If the liability of the surety is unclear, the bond is defective.").

<sup>73</sup> Enclave One, Inc., B-232383, 88-2 CPD ¶ 488.

<sup>74</sup> E.C. Devel., B-231523, 88-2 CPD ¶ 285; see e.g. Pamfilis Painting, B-247922, 92-1 CPD ¶ 521, at 3 ("agency ultimately determined that Pamfilis' individual surety was unacceptable and that Pamfilis was nonresponsive for this reason."); Enclave One, B-232383, 88-2 CPD ¶ 488, at 3 ("Enclave was therefore found to be nonresponsive based upon the unacceptability of its individual sureties and its bid was rejected.").

<sup>75</sup> FAR 9.103(b); see also Enclave One, B-232383, 88-2 CPD ¶ 488, at 3 ("Although a determination of nonresponsibility based upon the financial acceptability of an individual surety may be based upon information submitted any time prior to award, that determination may not be waived as no award may be made without an affirmative determination of responsibility.").

Many defects or omissions relating to the acceptability of proposed individual sureties as reflected on the Affidavit of Individual Surety and related documents, rather than the bid bond itself,<sup>76</sup> are treated as responsibility issues.<sup>77</sup> For a contractor the distinction between treatment of a defect as a responsiveness rather than responsibility issue is significant. A contractor may establish the responsibility of its individual sureties at any time prior to award of the contract, rather than at the time of bid opening.<sup>78</sup> Rather than suffer automatic rejection of its bid because of missing or inconsistent information relating to its individual sureties, the contractor may resolve inconsistencies, fix technical shortcomings and

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<sup>76</sup> Although a required submission, Standard Form 28, Affidavit of Individual Surety, is considered to be "a document separate from the bid bond itself . . . ." E.C. Devel., B-231523, 88-2 CPD ¶ 285, at 3; see also O.V. Campbell & Sons Industries, B-229555, 88-1 CPD ¶ 259, at 3 ("document separate"). "The accuracy of the information contained in the SF 28 . . . is a matter of responsibility." Enclave One, B-232383, 88-2 CPD ¶ 488, at 3; see also Gene Quigley, B-241565, 91-1 CPD ¶ 182, at 4 ("the SF 28 and related supporting documentation, such as the certificates of title and pledges of assets, serve solely as an aid in determining the responsibility of an individual surety.").

<sup>77</sup> Burtch Const., B-240695, 90-2 CPD ¶ 423 (individual surety's failure to submit a "pledge of assets" was a responsibility issue); Juniper Const. Co., B-232542, 88-2 CPD ¶ 561 (individual sureties' net worth on bid bond); E.C. Devel., Inc., B-231523, 88-2 CPD ¶ 285 (failure to disclose all outstanding bond obligations); See generally, Bednar, supra note 67, at 114 (noting Affidavit of Individual Surety defects, net-worth determinations, failure to submit a pledge of assets, and a surety's security interest in an asset).

<sup>78</sup> Burtch Const., B-240695, 90-2 CPD ¶ 423, at 2; Allied Production Management Co., B-236227, 89-2 CPD ¶ 534, at 3; see Bednar, supra note 67, at 90 ("Generally, responsibility defects are curable after bid opening, while responsiveness issues are not.").

provide omitted information to the government so long as these corrections are made prior to contract award.<sup>79</sup> However, the obligation to prove the surety's acceptability rests on the contractor<sup>80</sup> and a contracting officer's nonresponsibility determination will not be overturned so long as it is unreasonable.<sup>81</sup>

In a negotiated procurement, if a contractor within the competitive range provides a defective bid bond, the government must identify the deficiency and provide the contractor with an opportunity to correct it.<sup>82</sup> Should the contractor fail to correct the bond's shortcomings, the government may reject the contractor's proposal.<sup>83</sup> However, if the government elects to award the contract based on initial proposals, without discussion, failure to comply with the bid guarantee requirement

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<sup>79</sup> However, when the individual surety's integrity and credibility of representations is doubtful, the contracting officer may reject the bidding contractor as nonresponsible without further inquiry. Harrison Realty Corp., B-254461, 93-2 CPD ¶ 345; Gene Quigley, B-241565, 91-1 CPD ¶ 182, at 4-5.

<sup>80</sup> Pamfilis Painting, B-247922, 92-1 CPD ¶ 521, at 4.

<sup>81</sup> Id.; D.M. Potts Corp., B-231855, 88-2 CPD ¶ 440, at 2 ("Since a determination involves the exercise of subjective business judgments we will not disturb it unless it is shown to be unreasonable.").

<sup>82</sup> Communications by Johnson, B-255478, 94-1 CPD ¶ 163, at 5; accord Norse, B-233534, 89-1 CPD ¶ 293, at 5 (concerns about individual sureties "can be a subject of discussions.").

<sup>83</sup> Communications by Johnson, B-255478, 94-1 CPD ¶ 163, at 7-8.

usually mandates rejection of the contractor's proposal without opportunity to correct any deficiencies.<sup>84</sup>

## 2. Performance And Payment Bonds

As noted earlier, the Miller Act makes provision for two types of surety bonds: performance bonds and payment bonds. Used primarily in construction contracts,<sup>85</sup> the two different bonds "represent 'separate obligations running to separate obligees.'"<sup>86</sup>

The protections of a performance bond are primarily for the government's benefit.<sup>87</sup> This type of bond "secures performance and fulfillment of the contractor's obligations under the contract."<sup>88</sup> The FAR provides that the usual penal amount<sup>89</sup> of

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<sup>84</sup> FAR 28.101-3(b) (limited waiver provisions available).

<sup>85</sup> FAR 28.103-1(a).

<sup>86</sup> United States ex rel. Owens v. Olympic Marine Serv., 827 F. Supp. 1232, 1235 (E.D. Va. 1993) (citation omitted). For purposes of initiating a lawsuit, the two bonds are not interchangeable. Id.

<sup>87</sup> 40 U.S.C.A. § 270a(a)(1) (West 1986 and Supp. 1998) ("for the protection of the United States").

<sup>88</sup> FAR 28.001.

<sup>89</sup> "'Penal sum' or 'penal amount' means the amount of money specified in a bond (or a percentage of the bid price in a bid bond) as the maximum payment for which the surety is obligated or the amount of security required to be pledged to the Government in lieu of a corporate or individual surety for the bond." FAR 28.001.



such bonds is the full contract price.<sup>90</sup> In short, the bond ensures that the contractor will perform the contracted for work.<sup>91</sup>

In contrast, the payment bond protects suppliers and laborers. In the private sector, workers and materialmen enjoy the financial protection of state mechanic liens.<sup>92</sup> However, because a mechanics lien cannot attach to federal property, the Miller Act provided alternative protection in the form of a payment bond.<sup>93</sup> Indeed, one of the primary purposes of the Miller Act was "'to protect those who would have materialmen's and workmen's liens under state law if they were not working on a structure exempt as a federal public work or building.'"<sup>94</sup>

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<sup>90</sup> FAR 28.102-2(a) ("unless the contracting officer determines that a lesser amount would be adequate for the protection of the Government.").

<sup>91</sup> Donohue and Thomas, supra note 38, at 1 ("complete the project").

<sup>92</sup> Contract Bonds, supra note 14, at 10.

<sup>93</sup> J.W. Bateson Co. v. United States, 434 U.S. 586, 589 (1978); see also Toweridge, Inc. v. T.A.O., Inc., 111 F.3d 758, 760-1 n.1 (10th Cir. 1997) ("Because a lien cannot attach to federal property, those supplying labor or materials are instead protected by the payment bond."); United States v. WNH Limited Partnership, 995 F.2d 515, 518 (4th Cir. 1993); United States v. Mattingly Bridge Co., 344 F. Supp. 459, 461 (W.D. Ky. 1972) ("This security is necessary because such suppliers do not have enforceable rights for their compensation against the United States and cannot acquire a lien on property of the United States.").

<sup>94</sup> Blue Fox Inc. v. Small Business Admin., 121 F.3d 1357, 1359 n.1 (9th Cir. 1997) (citing United Bonding Ins. Co. v. Catalytic Constr. Co., 533 F.2d 469, 473 (9th Cir. 1976)).

Also known as a "labor and materials bond,"<sup>95</sup> the payment bond "assures payments as required by law to all persons supplying labor or material in the prosecution of the work provided for in the contract."<sup>96</sup> It ensures that the prime contractor pays its subcontractors,<sup>97</sup> by permitting suit against either the surety or the prime contractor.<sup>98</sup> For contracts less than \$1,000,000, the Miller Act requires the payment bond's penal sum to be one-half the contract value.<sup>99</sup> The penal sum increases to forty percent of the contract price for procurement between one and five million, with a maximum penal amount of \$2.5 million for any contract valued in excess of \$5 million.<sup>100</sup>

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<sup>95</sup> United States v. Daddona, 34 F.3d 163, 165 n.1 (3rd Cir. 1994).

<sup>96</sup> FAR 28.001

<sup>97</sup> Donohue and Thomas, supra note 38, at 1. However, the Miller Act's payment bond only covers first and second tier subcontractors; it does not protect third tier subcontractors or subcontractors of suppliers. Faerber Elec. Co. v. Atlanta Tri-Com, Inc., 795 F. Supp. 240, 243 (N.D. Ill. 1992); see also United States v. WNH Limited Partnership, 995 F.2d 515, 518 (4th Cir. 1993) ("limited to those who 'deal directly with the prime contractor' and those who 'have [a] direct contractual relationship with a subcontractor.'") (citation omitted).

<sup>98</sup> United States ex rel. Owens v. Olympic Marine Serv., 827 F. Supp. 1232, 1234 (E.D. Va. 1993).

<sup>99</sup> 40 U.S.C.A. § 270a(2) (West 1986 and Supp. 1997) ("shall be in a sum of one-half the total amount payable by the terms of the contract."); FAR 28.102-2(b)(i).

<sup>100</sup> 40 U.S.C.A. § 270a(2) (West 1986 and Supp. 1997); FAR 28.102-2(b)(ii) & (iii).

In the event of contractor default and the failure of an individual surety to honor its commitments,<sup>101</sup> a worthless payment bond can prove financially devastating to suppliers and materialmen. In one case where NASA terminated the prime contractor for default, subcontractors lost over \$750,000 because the individual sureties possessed insufficient assets or had vanished.<sup>102</sup> Because subcontractors enjoy no privity of contract with the United States, the latter is immune from suit. Miller Act surety bonds provide the sole source of funds for subcontractor payment claims.<sup>103</sup> Subcontractor attempts to recover losses under the Federal Torts Claim Act, 28 U.S.C. §§

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<sup>101</sup> See e.g. Hardaway Co. v. United States Army Corps of Engineers, 980 F.2d 1415, 1417 (11th Cir.), cert. denied, 510 U.S. 820 (1993) (subcontractor who was not paid after performance was "unable to obtain satisfaction of its judgment because it cannot locate the [individual] sureties or any of their assets.").

<sup>102</sup> Individual Sureties On Government Construction Contracts Need To Be Better Regulated, 136 Cong. Rec. S7681 (daily ed. June 11, 1990) (Statement of Senator Hatch). As an example of loss associated with individual surety bond fraud the GAO reported a case in which a subcontractor was unable to obtain payment for work performed on two separate contracts. Of the four individual sureties involved, one refused to honor a civil judgment, a second claimed he had signed a blank bond that had been fraudulently used, the third was in federal prison, and the fourth surety had disappeared. GAO Fact Sheet, supra note 3, at 18.

<sup>103</sup> Mr. Brad J. Hutchinson, B-230871, 96-1 CPD ¶ 282, at 3.

1346, 2671 et. seq.,<sup>104</sup> and Meritorious Claims Act, 31 U.S.C. § 3702(d),<sup>105</sup> have been rejected.

The government may terminate a contract for default if the contractor fails to timely provide acceptable payment and performance bonds.<sup>106</sup> This failure is not excused by virtue of the contractor's size or limited financial resources.<sup>107</sup>

#### **D. Types Of Sureties**

The FAR identifies two basic types of sureties, individual and corporate, who are "legally liable for the debt, default, or failure of a principal to satisfy a contractual obligation."<sup>108</sup> A

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<sup>104</sup> Hardaway Co. v. United States Army Corps of Engineers, 980 F.2d 1415, 1417 (11th Cir.) ("We thus hold that a subcontractor may not state a claim under the FTCA for the negligent failure to investigate the assets of a[n individual surety."), cert. denied, 510 U.S. 820 (1993); Priceless Sales And Service, Inc. v. United States, 959 F.2d 231 (4th Cir. 1992) (same).

<sup>105</sup> Mr. Brad J. Hutchinson, B-230871, 96-1 CPD ¶ 282 (contractor and individual sureties defaulted). Under the Meritorious Claims Act the Comptroller General may refer normally unpayable claims to Congress for payment based on unusual legal or equitable grounds. Id. at 3. However, in Hutchinson, the Comptroller General elected not to refer any such claims to Congress in the future because of the "continued referral to Congress of Miller Act bond claims such as these could create a de facto privity of contract between subcontractors and the government and result in liability on the part of the government where there currently is none." Id. at 4.

<sup>106</sup> Cole's Const. Co., ENGBCA No. 6074, 94-3 BCA ¶ 26,995; Pacific Sunset Builders, ASBCA No. 39312, 93-3 BCA ¶ 25,923.

<sup>107</sup> Cole's Const. Co., ENGBCA No. 6074, 94-3 BCA ¶ 26,995, at 134,448.

<sup>108</sup> FAR 28.001. The FAR also recognizes a "cosurety" which is one of at least two sureties jointly liable under the bond.

corporate surety is usually a licensed corporation chartered to serve as a surety<sup>109</sup> and corporate sureties provide the primary source of surety bonds on federal construction contracts.<sup>110</sup> Generally, corporate sureties are large entities with sufficient capital to make substantial financial commitments.<sup>111</sup> Because most corporate sureties are insurance companies, their regulation and licensing comes under the authority of state insurance commissioners.<sup>112</sup>

Corporate sureties are recognized by the FAR as an entity possessing the "legal power to act as surety for others,"<sup>113</sup> and are the most common means of satisfying the Miller Act's bond requirements.<sup>114</sup> Additionally, corporate sureties maintain sufficient capital for loss payments, the adequacy of which "is

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Id.

<sup>109</sup> FAR 28.001; see also GAO fact sheet, supra note 3, at 1 ("A corporate surety is generally a corporation that is licensed under various insurance laws and, under its charter, has legal power to act as a surety for others.").

<sup>110</sup> Access To Private Bonding Markets, 55 Fed. Reg. 4499, 4500 (1990) ("Corporate surety bonding companies are the principal source of surety bonding for both public and private construction contracts.").

<sup>111</sup> The Basic Bond Book, supra note 61, at 1 ("as large financial institutions, have the capital necessary to enable them to make large commitments in the form of surety bonds.")

<sup>112</sup> Id.; see John Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967 ("often supplied by large insurance firms"); Brady, supra note 36, at 46 ("Most construction surety bonds are written by the surety bond departments of large insurance companies.").

<sup>113</sup> FAR 28.001.

<sup>114</sup> Donohue and Thomas, supra note 38, at 4.

determined by independent auditors and actuaries, the surety's actuaries and/or state regulatory officials."<sup>115</sup> Before they may be used to support a federal contract, corporate sureties must be reviewed and approved by the government.<sup>116</sup> Only corporate sureties listed in Department of Treasury Circular 570, "Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and Acceptable Reinsuring Companies," may be used in satisfaction of the Miller Act's bonding requirements on domestic contracts.<sup>117</sup> Historically, corporate sureties have not proven problematic from a fraud perspective.<sup>118</sup>

In contrast, largely because of the reduced safeguards seen in the program, individual sureties have been a constant source of concern for agency procurement officials.<sup>119</sup> An individual

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<sup>115</sup> GAO Fact Sheet, supra note 3, at 30.

<sup>116</sup> John Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967 ("financial wherewithal is reviewed and approved by the Treasury Department."); accord GAO Fact Sheet, supra note 3, at 2.

<sup>117</sup> FAR 28.202(a)(1); see also Communications by Johnson, B-255478, 94-1 CPD ¶ 163, at 3 n.1; cf. Bednar, supra note 67, at 111 ("A bid bond properly submitted will render a bid nonresponsive if the named corporate surety is not Government-approved at the time of bid opening by the Treasury Department Circular 570."). Sureties not listed on the Treasury Department Circular may be used for contracts performed overseas if approved sureties are unavailable. FAR 28.202(b).

<sup>118</sup> Lieutenant Colonel Rothlein Et Al., Army Procurement Fraud--Recent Developments, Army Law., June 1992, at 53, 55 ("To date, few problems involving corporate sureties have arisen.")

<sup>119</sup> Id. at 55 ("Frauds involving individual sureties, however, have generated extensive publicity; have resulted in significant dollar losses to the government; and have led to numerous criminal investigations, prosecutions, and convictions.").

surety is a human being who is liable for a specified amount of money or pledged security, as listed in the bond, which is known as the "penal amount of the bond."<sup>120</sup> Usually, an individual surety is a person who is willing, either directly or through a broker, to post an asset as collateral for an individual surety bond.<sup>121</sup> Absent a debarment or other declaration of ineligibility for participation in federal procurement, anyone with the requisite assets may serve as a individual surety or an agent for such a surety. Historically, individual sureties have neither been regulated by the States not subject to Treasury Department approval.<sup>122</sup>

Unfortunately, individual sureties often unwittingly facilitate programmatic fraud. Not all individual sureties are savvy business men or women; many are merely unsophisticated property owners who are persuaded to permit their assets to be used to secure an individual surety bond. A GAO investigation of problems with the program revealed instances in which individual sureties signed blank bonds.<sup>123</sup>

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<sup>120</sup> FAR 28.001.

<sup>121</sup> John R. Emshwiller, Firms Hurt in U.S. Contracting Scandal May Get Help, Wall St. J., May 31, 1990, at B2 ("An individual surety is supposed to be a well-heeled person who for a fee from the prime contractor provides financial-guarantee bonds on a government building project.").

<sup>122</sup> Access To Private Bonding Markets, 55 Fed. Reg. 4499, 4500 (1990) ("Individual sureties are not regulated by state insurance departments nor approved by the Treasury Department."); accord GAO Fact Sheet, supra note 3, at 2.

<sup>123</sup> GAO Fact Sheet, supra note 3, at 18 ("one surety signed an affidavit stating that he only signed a blank bond and that

Additionally, unsophisticated individual sureties may sign Standard Form 28, Affidavit of Individual Surety, without knowing its meaning and content. This is significant because contracting officers use the information provided on the SF 28 to determine the acceptability of the individual surety.<sup>124</sup> Additionally, fraudulent brokers have been known to simply forge the surety's signature on applicable documentation and use the surety's real property as bond collateral without notifying the individual.<sup>125</sup> Other brokers have submitted photocopies of forged or altered documents in support of individual surety bonds, that were accepted by contracting officers.<sup>126</sup> Significantly, the FAR fails

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any further use of that bond was a fraudulent use of his signature.") & 19 ("One of the sureties involved acknowledged signing a blank bond but disclaimed any knowledge of or responsibility for the contract in question."); see also United States v. Upton, 91 F.3d 677, 680 (5th Cir. 1996) (individual surety signed blank performance and payment bonds).

<sup>124</sup> Clearance Request For Standard Form 28, Affidavit Of Individual Surety, 60 Fed. Reg. 46166, 46167 (1995) ("The information on SF 28 will be used to assist the contracting officer in determining the acceptability of individuals proposed as sureties."); see also E.C. Development, Inc., B-231523, 88-2 CPD ¶ 285, at 3 ("The SF-28 . . . is a document separate from the bid bond itself and serves solely as an aid in determining the responsibility of an individual surety."). The individual surety's net worth, as reflected on the SF 28, must be at least as much as the penal sum of the bond. 60 Fed. Reg. at 46167

<sup>125</sup> Telephone Interview with Special Agent Jeff Arsenault, Defense Criminal Investigative Service, June 2, 1998 [hereinafter Arsenault Interview]; cf. Dry Roof Corp., ASBCA 29061, 88-3 BCA ¶ 21,096, at 106,504 (contractor's vice president forged signature of individual surety). SA Arsenault has investigated a number of individual surety bond cases.

<sup>126</sup> Recent investigations revealed that many contracting office's failed to require original documents and signatures on such documentation as appraisals, Affidavits of Individual Surety, and attachments to such documents. Arsenault Interview,



to provide any safeguards in the form of restrictions on those individuals and entities that act as surety brokers or middlemen between contractors and individual sureties. One safeguard against fraud contained in the FAR, the notarization requirement for signatures,<sup>127</sup> has proven easily circumvented.<sup>128</sup>

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supra note 125. Normally photocopies of such documents are unacceptable. See Jay-Brant Gen. Contractors, B-274986, 97-1 CPD ¶ 17, at 4 ("Photocopies of bid guarantee documents generally do not satisfy the requirement for a bid guarantee since there is no way, other than by referring to the original documents after bid opening, for the contracting agency to be certain that there had not been alterations to which the surety had not consented and could use as a basis to disclaim liability.").

<sup>127</sup> See e.g. FAR 28.203-3 (Lien on Real Estate); Standard Form (SF) 28, Affidavit of Individual Surety, block 12.

<sup>128</sup> See e.g. Upton, 91 F.3d at 681 n.6 (misdemeanor plea for individual who falsely notarized individual surety's signature on SF 28); United States v. Turner, No. CR-96-130-PHX-SMM (D. Az., filed Feb. 16, 1997) (false notarization).

Until recently, the Army employed another safeguard for individual surety bonds, requiring all payment and performance bonds to be forwarded to the Office of the Chief Trial Attorney, Contract Appeals Division (CAD), for legal review. Christine S. McCommas, New Developments In Fighting Individual Surety Bond Fraud, Army Law., (Jan. 1990), at 56 (citing AFARS 28.106-90). As of October 1997, the requirement for CAD review was deleted and local offices are now required to conduct their own legal review of surety bonds. Major David A. Wallace Et Al., Contract Law Developments of 1997--The Year In Review, Army Law., (Jan. 1998), at 3, 47.

### III. The Individual Surety Bond Program

#### A. Purpose

The individual surety bond program is one of several socioeconomic programs found in the federal procurement system, and is one of two such programs dealing specifically with surety bonds. The other socioeconomic program being the Small Business Administration's (SBA) Bond Guarantee Program.<sup>129</sup> Small businesses, particularly minority contractors, have been historically dependent upon the individual surety bond program to compete for federal contracts. Many small and minority contractors are unable to obtain corporate bonds because they are either financial risks or have exhausted existing bonding capacity with its corporate sureties.<sup>130</sup> The Individual Surety

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<sup>129</sup> The SBA's bond guarantee program is designed to "assist small businesses in obtaining bonds for a variety of purposes including bonds to satisfy Miller Act requirements." Access To Private Bonding Markets, 55 Fed. Reg. 4499, 4500 (1990). Currently, the SBA will guarantee bid, performance and payment bonds against a percentage of loss ranging from 70%-90% in case of contractor default, for contracts valued at less than \$1.25 million. Small Business Administration, The Facts About The Surety Bond Guarantee Program 1 (1998). For this guarantee, both the surety company and the contractor pay a fee to the SBA. *Id.* at 4. The SBA program applies to surety bond companies listed on Treasury Department Circular 570. *Id.* at 3.

<sup>130</sup> See e.g. Cole's Const. Co., ENGBCA No. 6074, 94-3 BCA ¶ 26,995, at 134,446 ("Because of the size of this contract and the value of its other concurrent contracts, Cole's had exhausted its bonding capacity with corporate sureties."); see also Barbara Thiede, SBA Aids Minority Firms With Bonding Program, Bus. J. - Charlotte, Nov. 10, 1997, at 34 (small and minority contractors have difficulty obtaining bonding because they have difficulty establishing financial solvency and an adequate work history for larger construction projects); John R. Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb 15, 1989, 1989 WL-WSJ 481967 ("minority contractors have difficulty getting backing

Bond Program allows contractors, who are unable to secure corporate bonds, to meet the bonding requirements for federal construction contracts.<sup>131</sup> In 1989, the National Association of Minority Contractors opined "that without individual sureties, 75% of the minority-group contractors doing business with the federal government would be forced to stop."<sup>132</sup>

Unfortunately, the same reasons that make the individual surety bond program an invaluable component of the procurement system for small businesses also facilitates fraud. Small businesses, particularly women and minority owned, are often desperate for individual surety bonds, being unable to obtain

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from a corporate surety because they tend to be younger companies and haven't had the time to build up the necessary track record and net worth."); cf. 141 Cong. Rec. S5142-02, S5144 (daily ed. Apr. 4, 1995) (statement of Sen. Simon introducing The Equal Surety Bond Opportunity Act Of 1995) ("The American Subcontractors Association also presented testimony . . . . that women and minority-owned construction companies face special problems getting bonds, as do many small and emerging construction firms."); Major Anthony Helm, Bid Guarantee And Surety Bond Update, Army Law. 30, 31 (Aug. 1992) (construction contractors permitted to "submit irrevocable letters of credit in lieu of performance and payment bonds . . . . [as a means] to enhance the competitive positions of small businesses, which often have difficulties obtaining surety bonds.")

<sup>131</sup> GAO Fact Sheet, supra note 3, at 2.

<sup>132</sup> John R. Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967 (statement of Ralph Thomas, Executive Director); see also GAO Fact Sheet, supra note 3, at 30 ("associations representing minority contractors . . . . [reported to GAO] that individual sureties are currently the only form of bonds available to many minority contractors and that their elimination would have an adverse effect on the ability of minorities to bid on federal construction contracts.").

bonding elsewhere. This desperation makes small contractors acutely vulnerable to fraudulent bond schemes.<sup>133</sup>

## **B. Current FAR Requirements, Deficiencies And Suggested Changes**

### **1. General**

On February 26, 1990, the FAR provisions dealing with individual surety bonds underwent substantial change.<sup>134</sup> These changes were in response to the massive fraud infecting the individual surety bond program.<sup>135</sup> Of significance to this work, individual sureties were required to submit a pledge of security interest in assets equal to the penal sum of the bond, which in the case of pledged land meant a lien recorded in the government's favor supported by a certificate of title.<sup>136</sup> Also,

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<sup>133</sup> See State Charges Agent In Surety Bond Fraud, Boston Globe, Jan. 18, 1992, at 18 (the defendant "'allegedly preyed upon women and minority owned small business owners precisely because they were unable to obtain surety bonds from other sources' . . . ."); Sureties: Surety Broker Sentenced To Nine Years In Jail For Fraudulent Bond Scheme, 52 Fed. Cont. R. 1003 (Dec. 4, 1989) ("The 25-count indictment alleged that the defendants had advertised bonding services, especially to companies that were experiencing difficulty in obtaining performance and payment bonds.").

<sup>134</sup> Gene Quigley, Jr., B-241565, 91-1 CPD ¶ 182, at 3 ("extensively revised").

<sup>135</sup> Sureties: Surety Broker Sentenced To Nine Years In Jail For Fraudulent Bond Scheme, 52 Fed. Cont. Rep. 1003 (Dec. 4, 1989) ("The [FAR] changes are the result of ongoing federal investigations into surety fraud across the country, according to the Army Judge Advocate General's Office.").

<sup>136</sup> New Demands For Individual Sureties, Army Law., Mar. 1990, at 40. Assets other than real property were required to be placed in escrow. Id.; cf. Gene Quigley, Jr., B-241565, 91-1 CPD

the FAR was revised to exclude individuals from acting as individual sureties, when in the government's best interests; excluding these individuals through agency suspension, debarment or ineligibility procedures.<sup>137</sup>

In support of an individual surety bond under the current version of the FAR, the surety must pledge assets whose unencumbered value equals or exceeds the penal amount of the bond.<sup>138</sup> Acceptable assets include cash or cash equivalents, United States securities, actively traded stocks and bonds, real property, and irrevocable letters of credit.<sup>139</sup> FAR examples of unacceptable assets include notes and accounts receivable, foreign securities and real property, the surety's principal residence, real property owned in common with another person not electing to pledge the property or held in certain types of fee estates, certain types of personal property, stocks and bonds linked to or controlled by the contractor, corporate physical property, letters of credit, and speculative assets such as

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¶ 182, at n.2 ("Previously, individual sureties did not have to provide security interests in assets.").

<sup>137</sup> New Demands For Individual Sureties, supra note 136, at 41. FAR, subpart 9.4 was modified to specifically preclude from the procurement process any contractor suspended, debarred or proposed for debarment. Id.

<sup>138</sup> FAR 28.203(b). The bond's unencumbered value is "exclusive of all outstanding pledges for other bond obligations . . . ." Id. Up to three individual sureties may pledge their assets in support of a bond. Id.

<sup>139</sup> FAR 28.203-2(b).

mineral rights.<sup>140</sup> Assets found unacceptable under interpretive case law have included "liquid gold,"<sup>141</sup> and "lode mining claims."<sup>142</sup>

## 2. Evidence Of Ownership

Individual sureties may secure bonds with real property.<sup>143</sup> Unfortunately, the FAR fails to adequately require proof that the individual surety actually owns the land posted as collateral. Recent criminal investigations have shown individual sureties claiming ownership of military bombing ranges, the Joshua Tree National Monument, a Marine Corps training area and land belonging to the Bureau of Land Management.<sup>144</sup>

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<sup>140</sup> FAR 28.203-2(c).

<sup>141</sup> Cole's Const. Co., ENGBCA No. 6074, 94-3 BCA ¶ 26,995 (liquid gold).

<sup>142</sup> Jay Jackson & Assoc., B-271236, 96-2 CPD ¶ 111 (mining claim rejected as too speculative).

<sup>143</sup> FAR 28.203-3.

<sup>144</sup> Seth Rosenfeld, 2 Bay Area Men Charged In Scam, San Fran. Exam., Dec. 21, 1993, at A8 ("one [surety] said he owns 300,000 acres in California - but it turned out part of the land was in Joshua Tree National Monument and the rest used as a military bombing site."); Arsenault Interview, supra note 125 (BLM & USMC land during 1995-7 investigation); cf. Harrison Realty Corp., B-254461, 93-2 CPD ¶ 345 (contracting officer discovered that individual sureties did not own land as they claimed). Less recent examples of false claims to land ownership also exist. See e.g. Rothlein, supra note 118, at 55 (An individual surety "claimed to own 150,000 acres of land worth \$60 million. Investigators later discovered that this property actually belonged to the Bureau of Land Management."); John R. Emshwiller, United Funding & Investors Catches Government's Eye, Wall St. J., Apr. 3, 1989, 1989 WL-WSJ 501033 (individual surety claimed ownership to land in Imperial County, California that was listed

(a) Fee Simple Absolute

Currently, the FAR requires an individual surety to provide "[e]vidence of title in the form of a certificate of title prepared by a title insurance company approved by the United States Department of Justice."<sup>145</sup> This evidence of title must "show **fee simple** title vested in the surety with any concurrent owners . . . ."<sup>146</sup>

The FAR's use of the term "fee simple," instead of the apparently intended term "fee simple absolute," engenders unnecessary confusion. An estate held in fee simple absolute affords the greatest ownership interest in that real property. This type of estate "denotes the maximum of legal ownership, the greatest possible aggregate of rights, privileges, powers and

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in the tax records as being federal land).

<sup>145</sup> FAR 28.203-3(a)(1). The FAR does not elaborate on the "form" of a certificate of title that is acceptable. However, forms rejected as unacceptable have included: a "Commitment of Title Insurance" that failed to establish the surety's vested interest in the property; a "litigation guarantee," a "property profile" prepared by a title insurance company disclaiming any representations as to the surety's title in the land; and a "Special Report" indicating that the surety possessed "'title to the fee estate' in the property . . . ." Communication By Johnson, B-255478, 94-1 CPD ¶ 163, at 6 (Commitment of Title Insurance); Pamfilis Painting, B-247922, 92-1 CPD ¶ 521, at 3 & 4 (litigation guarantee & property profile); Don Kelland Materials, B-245801, 92-1 CPD ¶ 135 at 3 (Special Report).

<sup>146</sup> FAR 28.203-3(a)(1) (emphasis added).

immunities which a person may have in land; it is of potentially infinite duration."<sup>147</sup>

In contrast, there exists more than one type of fee simple. In addition to fee simple absolute, a fee simple estate may be defeasible.<sup>148</sup> A fee simple defeasible may terminate upon the occurrence of some future event.<sup>149</sup> Defeasible fees come in three forms. First, a fee simple determinable is a type of fee that ends automatically upon the occurrence of a specified event.<sup>150</sup> The land may be conveyed to a third party, but that party takes the land subject to the original conditions.<sup>151</sup> For example, the land may have been conveyed to the individual surety only so long as the land is used for a specific purpose,<sup>152</sup> which may not permit the use of the land in support of a surety bond. If, while the land is used to secure a bond, the individual surety

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<sup>147</sup> Ralph E. Boyer, Survey Of The Law Of Property 12 (3rd ed. 1981)

<sup>148</sup> Jesse Dukeminier and James E. Krier, Property 368 (1981) ("The fee simple may be absolute . . . [o]r the fee may be defeasible." (emphasis in original)).

<sup>149</sup> Id.; see also Black's Law Dictionary 554 (5th ed. 1979) ("may end upon the happening of a specified event . . . .") (citation omitted).

<sup>150</sup> Dukeminier & Krier, supra note 148, at 368; Boyer, supra note 147, at 14; see also United States Trust Co. of N.Y. v. State of New Jersey, 226 N.J. Super 8, 12, 543 A.2d 457, 460 (N.J. Super. Ct. App. Div., 1988).

<sup>151</sup> United States Trust Co., 226 N.J. Super at 12, 543 A.2d at 460.

<sup>152</sup> Dukeminier & Krier, supra note 148, at 368 (school purposes).



changes the use of the land, ownership automatically reverts to the original grantor or his or her heirs.<sup>153</sup>

The second type of fee simple defeasible is the fee simple subject to condition subsequent, which may be terminated at the transferor's election upon the occurrence of a stated event rather than terminating automatically.<sup>154</sup> The third type is a fee simple subject to an executory limitation, which means that upon the occurrence of the stated event ownership automatically transfers to some third party rather than to the original transferor.<sup>155</sup>

The problem in semantics is further aggravated by the synonymous treatment that the two terms receive by some legal authorities<sup>156</sup> and practitioners.<sup>157</sup> Albeit the terms are often

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<sup>153</sup> "Every fee simple determinable is accompanied by a future interest. In the ordinary case the future interest is retained by the transferor . . . or his heirs, and is called a possibility of reverter."). Dukeminier & Krier, supra note 148, at 368 (emphasis in original); see also Boyer, supra note 147, at 14.

<sup>154</sup> Dukeminier & Krier, supra note 148, at 368-9.

<sup>155</sup> Id. at 369-70.

<sup>156</sup> See e.g. Black's Law Dictionary 554 (5th ed. 1979) ("Fee simple signifies a pure fee; an absolute estate of inheritance . . . the largest estate and most extensive interest that can be enjoyed in land."); Steven H. Gifis, Law Dictionary 82 (1975) (fee simple is also called fee simple absolute); George W. Warvelle, Principles Of The American Law Of Real Property 77 (3rd ed. 1909) ("customary to describe it as a 'fee-simple' or even a 'fee-simple absolute.'"); Emory Washburn, 1 A Treatise On The American Law On Real Property 77 (1876) ("a fee-simple absolute simply means a 'fee-simple.'"; Etheridge v. United States, 218 F. Supp. 809 (E.D.N.C. 1963) (terms used interchangeably).

<sup>157</sup> Thomas F. Bergin and Paul Haskell, Preface To Estates In Land And Future Interests 24 (2d ed. 1984) (lawyers often refer

used interchangeably, there is a legal distinction between fee simple absolute and fee simple. As explained above, one type of fee simple, the fee simple defeasible, is an estate that - unlike fee simple absolute - may "come to an end before the line of heirs runs out by operation of a 'special limitation,' a 'condition subsequent,' or an 'executory limitation' attached to it at the time of its creation."<sup>158</sup>

The importance of the distinction may become important in terms of "materiality" during a prosecution for a false statement in violation of 18 U.S.C. § 1001.<sup>159</sup> To illustrate, in a recent criminal case, a title report indicating that the purported owner enjoyed a "fee estate" in the land<sup>160</sup> was altered to reflect the term "fee simple estate" and then submitted to the United States

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to "fee simple absolute" as "fee simple" or even just "fee"); cf. Henry A. Babcock, Appraisal Principles And Procedures 34 (1980) ("When the title to a piece of real estate is vested in a party in fee simple, the party's property interest is absolute or complete . . . .") (emphasis in original).

<sup>158</sup> Bergin and Haskell, supra note 157, at 23 (emphasis in original).

<sup>159</sup> A materially false statement is one that has "'a natural tendency to influence, or [be] capable of influencing, the decision of the decisionmaking body to which it was addressed.'" United States v. Gaudin, 115 S.Ct. 2310, 2313 (1995) (citation omitted).

<sup>160</sup> This was not the first time that such language in a title report was presented to a contracting officer in support of an individual surety bond. In Don Kelland Materials, B-245801, 92-1 CPD ¶ 135, the evidence of title to the collateral real property presented to the contracting officer was a title report, labeled a "Special Report," prepared by a subsidiary of an approved title insurance company, indicating only "title to the fee estate" in the property."

as part of a surety bond package for a federal construction contract.<sup>161</sup> Because the individual surety had obtained the land by a quit claim deed<sup>162</sup> and ownership to the surety's property was in dispute, the title company was unwilling to render a title report reflecting the language "fee simple" or "fee simple absolute."<sup>163</sup> Absent the FAR required language, the contracting officer refused to accept the individual surety bond.<sup>164</sup>

The defense took the position that no legal distinction existed between those two terms.<sup>165</sup> Arguably, the synonymous treatment of the two terms by some legal authorities would undercut the prosecution's ability to establish the materiality of the false statement. Because the FAR's use of the term fee simple is imprecise and capable of generating confusion, coupled with the fact that the materiality of a false statement is an issue for the jury,<sup>166</sup> a potential defense existed.<sup>167</sup> Even after

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<sup>161</sup> Arsenault Interview, supra note 125.

<sup>162</sup> A Quit Claim Deed "conveys only that right, title, or interest which the grantor has, or may have, and which does not require that the grantor thereby pass a good title." Gifis, supra note 156, at 169.

<sup>163</sup> Arsenault Interview, supra note 125.

<sup>164</sup> Id.

<sup>165</sup> Id.

<sup>166</sup> United States v. Gaudin, 115 S.Ct. 2310 (1995).

<sup>167</sup> "Yet, it is in the area of 'materiality' that the most efficacious preindictment, as well as trial and appeal arguments, may be fashioned. That the falsity was not important--i.e., material--is often a persuasive argument to prosecutors not to indict or juries not to convict." Stanley S. Arkin, 6 Business Crime ¶ 35.03[4], 35-12 (1990 & Supp. 1994) (emphasis in

the defendants entered guilty pleas on related misconduct,<sup>168</sup> the defense submitted affidavits of experts witnesses in mitigation, again taking the position at sentencing that no legal distinction existed between the two terms.<sup>169</sup>

Clearly, the FAR's use of the term fee simple, rather than fee simple absolute, creates an unnecessary source of potential confusion that can easily be remedied by altering the FAR to read "fee simple absolute" rather than "fee simple." In addition, FAR language should be added to section 28.203-2(c) putting sureties

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original).

A false statement is material if it is capable of influencing action; actual reliance is not required. United States v. Menichino, 989 F.2d 438, 440 (11th Cir. 1993). Although a government expert cannot testify that a false statement was "material" because expert witnesses may not express an opinion of law, the prosecution can legitimately elicit testimony concerning "whether the false statements in this case would have 'the capacity to influence' . . . ." United States v. Lueben, 812 F.2d 179, 184 (5th Cir. 1987).

<sup>168</sup> United States v. Novick, No. CR-97-61-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997) (causing a false Certificate of Title to be made in violation of 18 U.S.C. § 1001); United States v. Wisse, CR-96-379-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997) (conspiracy in violation of 18 U.S.C. §§ 371, 641; forging the signature on a false certificate of title); United States v. MGA Bonding And Assurance Inc., No. CR-97-61-PHX-SMM (D. Az. Plea Agreement filed Feb. 13, 1997) (false statement).

<sup>169</sup> United States v. MGA Bonding & Assurance, Inc., No. 97 CR 00061-002-PHX-SMM (D. Az. filed Jun. 24, 1997) (Notice Of Filing Expert Affidavits) ("No legally significant difference exists between the terms 'fee estate' and 'fee simple estate.'") ("The terms 'fee simple estate' and 'fee estate' denote the same ownership in real property."). The affidavits were filed on behalf of defendants MGA, Wisse, and Novick. Id.

on notice that real property whose chain of title is dependent upon a quit claim deed is an unacceptable asset.<sup>170</sup>

**(b) Increased Role Of The Appraiser: Ownership Verification**

Surprisingly, a potential means of verifying actual ownership of the real property - verification by the appraiser - does not exist. Anecdotal evidence indicates that appraisers of land for use with individual surety bonds did not always verify ownership, and in some cases did not personally examine the subject land.<sup>171</sup> In Communications by Johnson, a Veterans Administration contracting officer discovered that land offered as collateral for a bid bond was not owned by the purported individual surety, notwithstanding that an appraisal had been submitted on the surety's behalf.<sup>172</sup>

The FAR requires that an appraisal used in support of a land-based individual surety bond be prepared in accordance with

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<sup>170</sup> A quitclaim deed puts the grantee on notice "that he is getting a doubtful title." Aud v. Illinois Cent. Railroad Co., 955 F. Supp. 757 (W.D. Ky. 1997).

<sup>171</sup> Helm, supra note 17, at 25 (contracting officer "discovered that the real property appraiser merely made a rough estimate of value, only looked at some of the land, and did not even verify ownership of the property."); see also Arsenault Interview, supra note 125 (evidence appraiser neither verified ownership nor personally examined land).

<sup>172</sup> B-255478, 94-1 CPD ¶ 163. The appraiser was Joe B. Hunt and the President of the broker company acting as the surety's "authorized representative" was Don DeSanti. Id. at 3. Both were later convicted of surety bond fraud related offenses. See note 12 supra.

The Uniform Standards of Professional Appraisal Practice (USPAP), as promulgated by the Appraisal Foundation.<sup>173</sup> The Foundation was created in 1987 to establish standards for self-regulation in the appraisal industry following the savings and loan scandals of the early 1980s.<sup>174</sup> In 1989, Congress authorized the Foundation to establish industry standards for federally regulated transactions.<sup>175</sup>

Unfortunately, neither USPAP nor the FAR contain any requirement that an appraiser actually verify ownership. Indeed, USPAP's only requirement concerning land inspection is that the appraiser indicate, in a signed certification accompanying the appraisal, whether a personal inspection of the property was made.<sup>176</sup>

Assuming that the cost of a full title search would be too expensive for a program designed to make surety bonds economically accessible to small businesses of limited financial means, the FAR could nevertheless require some substantiation that the purported surety actually owns the land in question. As

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<sup>173</sup> FAR 28.203-3(a)(3).

<sup>174</sup> National Assoc. Of Review Appraisers And Mortgage Underwriters v. The Appraisal Foundation, 64 F.3d 1130, 1132 (8th Cir. 1995), cert. denied, 517 U.S. 1189 (1996).

<sup>175</sup> Id. ("In 1989, Congress passed Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which charged the Foundation's Appraiser Standards Board and Appraiser Qualifications Board with promulgating industry standards for federally regulated transactions.").

<sup>176</sup> Appraisal Standards Board, The Appraisal Foundation, Uniform Standards Of Professional Appraisal Practice 24 (1998) [hereinafter USPAP].

a minimum, the appraiser, or individual surety, could be required under the FAR to provide a certified copy of the most recent county or municipal tax records listing the recorded owner of the property.<sup>177</sup> Any discrepancies in purported ownership should put the contracting officer on notice that further inquiry is required.

### 3. Inflated Appraised Value

Another shortcoming with the individual surety bond program is the absence of any meaningful mechanism to verify the accuracy of appraised land value. Frequently, in fraudulent surety bond scams the value of the property posted as collateral is inflated. Indeed, the individual surety bond fraud scandal of a decade ago was facilitated in large part by the ability of individual sureties to grossly inflate the value of their real estate holdings.<sup>178</sup> Surety bond fraud convictions have included appraisers who grossly inflated the appraised value of land used as collateral on the bonds.<sup>179</sup>

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<sup>177</sup> A 1989 check of tax records revealed that land claimed by an individual surety on NASA and Navy contracts was listed as being owned by the federal government. John R. Emshwiller, United Funding & Investors Catches Government's Eye, Wall St. J., Apr. 3, 1989, 1989 WL-WSJ 501033.

<sup>178</sup> John R. Enshwiller, Firms Hurt In U.S. Contracting Scandal May Get Help, Wall St. J., May 31, 1990, at B2 ("the individual surety market was invaded . . . by individuals whose prime asset turned out to be an ability to vastly inflate their own net worth on financial statements.")

<sup>179</sup> See e.g. United States v. Hunt, No. CR-95-299-PHX-RCB (D. Az., Sentenced April 8, 1996), affirmed, No. 96-10181 (9th

The motivation to inflate the value of real property is obvious. The FAR permits an individual surety to pledge real property in support of a bond up to 75% of its assessed market value.<sup>180</sup> The greater the appraised value of the property, the greater the number of surety bond liens that can be levied against it, and the greater the amount of premiums or fees that a surety and/or broker may collect.

The FAR requires the individual surety to provide either a current real estate tax assessment or a current appraisal.<sup>181</sup> The FAR should require both types of documents. One of the difficulties in prosecuting falsely inflated appraisals is that the appraisal process is an inexact science and reasonable minds may differ on real estate values.<sup>182</sup> At trial, a defendant may

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Cir. filed Mar. 14, 1997), cert. denied, 118 S.Ct. 130 (1997); see Douglas McLeod, Backed By Bogus Assets, Business Insur., Jan. 8, 1996, at 6 (two real estate appraisers indicted, and one pled guilty, for allegedly preparing "fraudulent appraisals inflating the value of the properties."); cf. United States v. Simpson, CR 98-263-PHX (D. Az., filed May 5, 1998) (appraiser indicted for providing inflated valuations in appraisals used with individual surety bonds).

<sup>180</sup> FAR 28.203-2(b)(4) ("75 percent of the properties' unencumbered market value provided a current appraisal is furnished.") Alternatively, real property may be accepted at 100 percent of its current tax assessed value. Id.

<sup>181</sup> FAR 28.203-3(a)(3). To be current, the appraisal must be dated "no earlier than 6 months prior to the date of the bond . . . ." Id. If not current, an agency may reject the appraisal as an unacceptable measure of property value. Gulf & Texas Trading Co., B-253991, 94-1 CPD ¶ 31.

<sup>182</sup> Harold D. Albritton, Controversies In Real Property Valuation: A Commentary 1 (1982) ("the appraisal discipline is not a scientific method whereby one may predict with complete confidence that two or more appraisers will produce identical or reasonably approximate value estimates.")



successfully claim incompetence, negligence, or a professional disagreement as to the land's value.<sup>183</sup> Appraisal values are in large part a judgment call.<sup>184</sup> It is only in the unusual case that the value of the land is so grossly inflated, or the appraisal so poorly performed, that a prosecutor will be able to take a case past these defenses and prove criminal misconduct beyond a reasonable doubt.<sup>185</sup>

A relatively easy and inexpensive solution to this problem is to require certified copies of the most recent tax assessments on any real property pledged in support of an individual surety bond. Although a tax assessment will generally reflect a lower property value than a real estate appraisal,<sup>186</sup> the assessment

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<sup>183</sup> Cf. In re Applin, 108 B.R. 253, 261 (E.D. Calif. 1989) ("Real estate appraisals generally lack the circumstantial guarantees of trustworthiness that are inherent in medical records containing diagnostic opinions. Their quality is uneven.")

<sup>184</sup> Federal Savings & Loan Insur. Corp. v. Derbes, 731 F. Supp. 755, 761 (E.D. La. 1990) ("The service real estate appraisers provide is the exercise of their judgment of the value of property of various kinds, property which differs in a variety of respects."). However, for purposes of criminal law, appraisals are more than "mere opinion" and may constitute a false statement. United States v. Faulkner, 17 F.3d 745, 770 (5th Cir. 1994) (conviction for making a false statement to a financial institution, in violation of 18 U.S.C. § 1014).

<sup>185</sup> See e.g. United States v. Tannehill, 49 F.3d 1049, 1056 (5th Cir. 1995) ("Government introduced expert testimony that the inconsistencies and unexplained adjustments in the appraisals could not be attributed to incompetence or negligence, and that an experienced appraiser should have detected them."); Faulkner, 17 F.3d at 769 (conviction obtained, in part, through expert testimony that appraisals were overvalued and that incompetence could not account for inconsistent appraisal adjustments.)

<sup>186</sup> Cf. Communication by Johnson, B-255478, 94-1 CPD ¶ 163, at 6 ("The agency reports that . . . tax assessed land value is

will at least give the contracting officer an independent gauge by which gross discrepancies in property value can be identified and investigated.<sup>187</sup>

#### 4. Surety Brokers

The single most salient shortcoming of the FAR with respect to protecting the integrity of the individual surety bond program is the FAR's complete failure to regulate those individuals and businesses acting as brokers, agents or middlemen between individual sureties and contractors. This shortcoming is particularly pronounced in light of the numerous cases in which these intermediaries orchestrated or actively facilitated

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generally less than current market value . . . ."). To some extent the FAR recognizes this disparity, permitting an individual surety to pledge 100% of the most current tax assessed value of the property or 75% of the appraised value. FAR 28.203-2(b)(4).

<sup>187</sup> See e.g. Communications By Johnson, B-255478, 94-1 CPD ¶ 163, at 6 ("An independent inquiry conducted by the VA reveals that the Maricopa County tax assessed value of the property, \$959,919, is far less than the alleged \$4,250,000 market value appraisal attested to by Mr. Hunt."); Douglas McLeod, Backed By Bogus Assets, Business Insur., Jan. 8, 1996, at 6 (property appraised at \$98.5 million but had a tax assessed value of only \$700,000).

individual surety bond fraud schemes,<sup>188</sup> and the recognition of the problem at least a decade ago.<sup>189</sup>

With the exception of provisions declaring individuals ineligible for participation in the procurement system generally, the FAR places imposes no restrictions or qualifications upon individuals or entities seeking to serve as individual surety

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<sup>188</sup> See e.g. United States v. Leahy, 82 F.3d 624, 628 (5th Cir. 1996) ("bonding agent"); United States v. West, 2 F.3d 66, 67 (4th Cir. 1993) ("matchmakers"); United States v. Joseph, 921 F.2d 282 (9th Cir. 1990) (Table), 1990 WL 212677, cert. denied, 499 U.S. 929 (1981) ("bonding brokers"); 2 Bay Area Men Charged In Scam, San Francisco Examiner, Dec. 21, 1993, at A8 (Convicted defendant's "company brokered more than \$100 million in bonds, lining up contractors who needed them with people who for a fee acted as sureties, pledging their personal assets to guarantee the construction work."); Broker Enters Guilty Plea Over Surety Bond Fraud, Wall St. J., Aug. 3, 1992, 1992 WL-WSJ 642409; Sureties: Surety Broker Sentenced To Nine Years In Jail For Fraudulent Bond Scheme, 52 Fed. Cont. Rep. 1003 (Dec. 4, 1989) (Arizona federal court sentenced broker "in connection with a scheme to furnish worthless performance and payment bonds on federal construction contracts."); cf. Electrical Generation Tech., B-235809, 89-2 CPD ¶ 204 (noting that individual surety bond brokerage under criminal investigation and three principals of the brokerage were indicted); J.B. Pierport and Darrell Preston, Feds Launch Nationwide Probe Of Fraud In Surety Bond Field, Wash. Bus. J., Apr. 29, 1991, at 6 (indicted individual sureties linked to broker company under criminal investigation); John R. Emshwiller, Three Men Indicted On Charges Involving Individual Sureties, Wall St. J., June 20, 1989, 1989 WL-WSJ 488488 (Dallas based indictment of "individual-surety brokerage firm").

<sup>189</sup> During a 1989 investigation into alleged criminal conduct by an individual surety bond brokerage that had brokered over \$400 million in contracts, a spokesman with the Army Corps of Engineers noted that one problem with the individual surety bond program was that no requirement existed to identify participating brokers. John R. Emshwiller, United Funding & Investors Catches Government's Eye, Wall St. J., Apr. 3, 1989, 1989 WL-WSJ 501033 ("brokers aren't required to be identified in a deal and often aren't.").

bond brokers.<sup>190</sup> In some instances, criminal investigations revealed that surety bond brokers convicted of surety bond fraud were already felons, including at least one broker who had previously been convicted of a surety bond-related offense.<sup>191</sup> As discussed in greater detail below, if the integrity of the individual surety bond program is to be maintained, the FAR must be altered to identify those brokers whose responsibility may be called into question.

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<sup>190</sup> Individuals suspended, debarred or proposed for debarment are excluded from participation as surety bond brokers. FAR 9.405(c). However, potential safeguards such as suspension and debarment proceedings and the Prohibited Employment Act, 10 U.S.C. § 2408, are unable to protect the integrity of the procurement system. See notes 230-37, 259-62 infra and accompanying text.

<sup>191</sup> Broker Enters Guilty Plea Over Surety Bond Fraud, Wall St. J., Aug. 3, 1992, 1992 WL-WSJ 642409 ("Mr. Manson was convicted in Dallas in 1980 in a case involving surety fraud and served time in jail, his attorney said."); see Arsenault Interview (broker previously convicted of a felony, but uncertain if it was related to surety bonds); cf. John R. Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Fe. 15, 1989, 1989 WL-WSJ 48196 (convicted felons provided individual surety bonds).

#### IV. POTENTIAL SAFEGUARDS AND ENFORCEMENT MECHANISMS

##### A. Suspension And Debarment

It is the United States' policy to award contracts only to responsible contractors.<sup>192</sup> Responsibility refers not only to a contractor's ability to perform, but also its honesty and integrity.<sup>193</sup> Prior to awarding the procurement, the contracting officer must make an affirmative responsibility determination.<sup>194</sup> The contractor, rather than the government, bears the burden of proof on this issue,<sup>195</sup> and must satisfy several enumerated threshold standards.<sup>196</sup> When in doubt as to the contractor's responsibility, the contracting officer must err on the side of

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<sup>192</sup> FAR 9.103(a).

<sup>193</sup> William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6; see also Lou Dominick, HUDBCA No. 87-2420-D31, 1987 WL 47421, at \* 2 ("'Responsibility' is a term of art in Government contract law, defined to include not only the ability to successfully perform a contract, but also the honesty and integrity of the contractor.").

<sup>194</sup> FAR 9.103(b), 14.408-2(a) (sealed bids); see also Cubic Corp. v. Cheney, 914 F.2d 1501, 1502 (D.C. Cir. 1990); Service Deli, B-276251, 97-1 CPD ¶ 110, at 2 ("No purchase or award may be made unless the contracting officer makes an affirmative determination of responsibility.").

<sup>195</sup> FAR 9.103(c); see also Cheney, 914 F.2d at 1502..

<sup>196</sup> The contractor must establish satisfactory financial resources; delivery or performance compliance capabilities; performance record; integrity and business ethics; organization, experience and skills; and necessary equipment or facilities. FAR 9.104-1.

protecting the government and declare the contractor nonresponsible.<sup>197</sup>

Designed to "effectuate" the government's policy of protecting the public interest by contracting only with responsible parties,<sup>198</sup> debarment and suspension actions have historically served as an often-used tool to protect the integrity of the federal procurement system.<sup>199</sup> Any risk to the procurement system associated with the participation of

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<sup>197</sup> FAR 9.103(b); see also Cheney, 914 F.2d at 1502; Service Deli, B-276251, 97-1 CPD ¶ 110, at 2 ("In the absence of information clearly indicating that the prospective contractor is responsible, the contracting officer is required to make a determination of nonresponsibility.").

<sup>198</sup> FAR 9.402(A). "Debarment is the means by which the Government effectuates its recognized obligation to protect the public interest. Its purpose is to assure that the Government only does business with responsible contractors, to prevent it from contracting with irresponsible contractors, and to insure that Government funds will be properly utilized." James H. Sandve, AGBCA No. 82-142-7, 1987 WL 40582, at \*6

<sup>199</sup> In 1990, the Army suspended or debarred 584 contractors for fraudulent activity or poor performance. Rothlein, supra note 118, at 53. The Army was the most proactive agency within the Defense Department in 1990. Id. During a single nine month period, the Army "suspended, proposed for debarment, or debarred sixty individual sureties." Id. at 55. In fiscal year (FY) 1997, the Defense Logistics Agency (DLA) took the lead as the most aggressive agency in this area. In FY 97 Department of Defense agency suspensions and debarments were as follows: DLA, 136 suspensions and 376 debarments; Army, 59 suspensions and 116 debarments; Navy, 39 suspensions and 113 debarments; and Air Force, 27 suspensions and 68 debarments. Telephone Interview with Richard Finnigan, DLA, July 2, 1998; Telephone Interview with William Finch, Office of the Deputy General Counsel for Contractor Responsibility, U.S. Air Force, July 2, 1998; Telephone Interview with Patricia Pappis, Acting Counsel, U.S. Navy Procurement Integrity Office, July 6, 1998; Telephone Interview with Brian Thorpe, Army Procurement Fraud Division, July 7, 1998.

irresponsible contractors is eliminated by removing the source of the risk.<sup>200</sup>

Because the effect of a suspension or debarment may be devastating to a business dependent upon federal contracts, these administrative actions may not be used in a punitive fashion.<sup>201</sup> A contractor debarred, suspended or proposed for debarment may not be awarded a contract, may not serve as an agent or representative of another contractor, and the agency may not solicit offers from it or permit such contractors to receive subcontracts.<sup>202</sup> Also, affiliates of debarred contractors may not

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<sup>200</sup> Caiola v. Carroll, 851 F.2d 395, 399 (D.C. Cir. 1988) ("Debarment reduces the risk of harm to the system by eliminating the source of the risk, that is, the unethical or incompetent contractor.").

<sup>201</sup> Debarments may not be used as a form of punishment; their use is limited to protecting the public interest in the federal procurement system. William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6; see also FAR 9.402(b) ("The serious nature of debarment and suspension requires that these sanctions be imposed only in the public interest for the Government's protection and not for purposes of punishment.").

<sup>202</sup> FAR 9.405(a). An agency head, or designee, may waive this prohibition for a "compelling reason." Id. Additionally, contractors may continue to perform existing contracts, unless the agency elects to terminate the contract. FAR 9.405-1. Additionally, a contractor who has been suspended or debarred may be denied an export license from the State Department and may lose its security clearance. Major Craig Wittman, The Effect of Suspension and Debarment On A Contractor's Ability To Obtain Export Licenses And Security Clearances, Army Law. (Oct. 1992), at 49.

be awarded a contract.<sup>203</sup> Significantly, the FAR specifically prohibits such contractors from acting as individual sureties.<sup>204</sup>

The grounds for a debarment or suspension are contained at FAR 9.406-2 and 9.407.2, respectively. In the individual surety bond fraud context, a debarment may be based upon a conviction or civil judgment for: (1) committing fraud or a criminal offense directly relating to a public contract or subcontract; (2) committing theft, forgery, record falsification or destruction, and false statements; or (3) "[c]ommission of any other offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a Government contractor or subcontractor."<sup>205</sup> A fact based debarment may be premised on the "[v]iolation of the terms of a Government contract or subcontract so serious as to justify debarment."<sup>206</sup> Finally, the FAR authorizes debarment for "[a]ny other cause of so serious or compelling a nature that affects the present responsibility of a Government contractor or subcontractor."<sup>207</sup>

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<sup>203</sup> South Texas Turbine Supply, B-272163, 96-2 CPD ¶ 105, at 3 (if affiliated with debarred contractor at time of bid opening, affiliate may not be awarded contract).

<sup>204</sup> FAR 9.405(c).

<sup>205</sup> FAR 9.406-2(a).

<sup>206</sup> FAR 9.406-2(b)(1)(i).

<sup>207</sup> FAR 9.406-2(c).



The period of debarment must be "commensurate with the seriousness of the cause(s)." <sup>208</sup> Although no ceiling exists, the FAR states that the period of debarment should not normally exceed three years. <sup>209</sup> However, federal agencies have imposed considerably longer periods of debarment. <sup>210</sup>

The grounds for a suspension are similar to the grounds for debarment except that a conviction or civil judgment is not required. <sup>211</sup> An indictment constitutes adequate evidence of the commission of the requisite misconduct. <sup>212</sup> The lower level of proof required reflects the temporary nature of the

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<sup>208</sup> FAR 9.406-4(a).

<sup>209</sup> FAR 9.406-4(a)(1). Conversely, the Defense FAR Supplement places a floor on the debarment period, noting that "[i]f a decision is based on a felony conviction, the period generally should be for more than one year." DFARS 209.406-4.

<sup>210</sup> See e.g. Coccia v. Defense Logistics Agency, 1992 WL 345106 (E.D. Pa.) (affirming fifteen year debarment); see United States v. Glymph, 96 F.3d 722 (4th Cir. 1996) (four years). The Navy debarred former Assistant Secretary of the Navy Melvyn Paisley for twenty-five years following his corruption convictions as a result of Operation Illwind, the defense industry corruption scandal of the 1980's. Pappis Interview, supra note 199. For a detailed discussion of Operation Illwind see generally Andy Pasztor, When The Pentagon Was For Sale (1995).

<sup>211</sup> FAR 9.407-2.

<sup>212</sup> FAR 9.407-2(b); see also Commercial Drapery Contractors v. United States, 133 F.3d 1, 4 (D.C. Cir. 1998) ("[Contractor's] indictment for the commission of such a criminal offense is sufficient to support its suspension."); see Rutigliano Paper Stock v. GSA, 967 F. Supp. 757, 767 (E.D.N.Y. 1997) (an indictment serves as a "rebuttable presumption that a suspension is justified").

administrative action.<sup>213</sup> Normally, a suspension will be terminated within 12 months of its initiation if legal proceedings have not commenced.<sup>214</sup>

Initially, the Government bears the burden of proving, by a preponderance of evidence, that grounds for a suspension or debarment exists.<sup>215</sup> A conviction or civil judgment is sufficient, by itself, to meet this requirement.<sup>216</sup> Even when a legitimate basis exists, the agency suspension and debarment

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<sup>213</sup> FAR 9.407-4(a) ("Suspension shall be for a temporary period pending the completion of investigation and any ensuing legal proceedings . . . ."); see also Commercial Drapery Contractors v. United States, 133 F.3d 1, 5 (D.C. Cir. 1998) ("[S]uspensions are temporary measures, available to the government so that it may protect itself from suspect contractors.").

<sup>214</sup> FAR 9.407-4(b). A six month extension may be granted to the government. Id.

<sup>215</sup> William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6; accord FAR 9.406-3(d)(3).

<sup>216</sup> Waterhouse v. United States, 874 F. Supp. 5, 8 (D.D.C. 1994) ("in the case of a conviction or civil judgment debarment is effectively automatic; because another fact-finder (a judge or a jury) has already found one of the bases for debarment beyond a reasonable doubt or by a preponderance of the evidence, there is no statutory, regulatory or due process requirement of an additional hearing to establish the underlying facts."); see Silverman v. Department of Defense, 817 F. Supp. 846, 849 (S.D. Calif. 1993) ("The facts underlying a conviction are, logically, not subject to dispute in a debarment proceeding, having been established beyond a reasonable doubt by the criminal adjudication"); Turner Lacey, Jr., HUDBCA No. 93-C-D46, 1994 WL 74946, at \*3 ("If the debarment action is based upon a conviction, the standard of proof is deemed to have been met.") (citing 24 C.F.R. § 24.313(b)(3)). The FAR only requires the Government to prove grounds for debarment when it does not rely upon a conviction or civil judgment. Cf. FAR 9.406-3(b)(1); United States v. Hatfield, 108 F.3d 67 (4th Cir. 1997) ("The cause for debarment, if not based on a conviction or judgment, must be established by 'a preponderance of the evidence.'") (citation omitted).

authority is not required to take such action.<sup>217</sup> When deciding whether to debar, the agency must consider the seriousness of the misconduct, mitigating circumstances, and any other relevant evidence.<sup>218</sup> Although frequently looking at past acts, the agency is ultimately concerned with the party's present responsibility.<sup>219</sup>

While speaking only in terms of a contractor, the FAR definition of that term is fairly broad. For purposes of suspension and debarment a contractor includes any person or entity that "[d]irectly or indirectly . . . submits offers for or is awarded, or reasonably may be expected to submit offers for or be awarded, a Government contract . . . ." <sup>220</sup> The definition also encompasses any agents or representatives of a contractor,<sup>221</sup> and

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<sup>217</sup> FAR 9.406-1(a) (debarment), 9.407-1(b)(2) (suspension); see also Silverman v. Department of Defense, 817 F. Supp. 846, 848 (S.D. Calif. 1993) ("While contractors who commit crimes may be debarred, the mere existence of such a cause does not compel debarment."); William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6 ("Existence of a cause for debarment does not automatically require imposition of a debarment.").

<sup>218</sup> William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6. "Respondent bears the burden of proving the existence of mitigating circumstances." Id.; FAR 9.406-1(a) ("if a cause for debarment exists, the contractor has the burden of demonstrating, to the satisfaction of the debarring official, its present responsibility and that debarment is not necessary."). A list of factors that the debarring official should consider in making the debarment determination is included at FAR 9.406-1(a).

<sup>219</sup> William James Gilbert, HUDBCA No. 95-G-130-D21, 1997 WL 235490, at \*6 ("The test for whether a debarment is warranted is present responsibility, although lack of present responsibility may be inferred from past acts.").

<sup>220</sup> FAR 9.403.

<sup>221</sup> Id.

any contractor affiliates.<sup>222</sup> Individual sureties,<sup>223</sup> appraisers,<sup>224</sup> surety brokers and other intermediaries fall within the ambit of such a broad definition, as does any person or entity that exercises the requisite level of control over them.<sup>225</sup> Further, the misconduct of the individual surety, or its agent, may be imputed to any contractor who knowingly uses fraudulent surety bonds.<sup>226</sup>

Although the broad definition of the term contractor permits an agency to suspend or debar all those falling under the definitional umbrella, the debarment of one individual or entity does not authorize the automatic debarment of all related parties.<sup>227</sup> These individuals are entitled to the "core

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<sup>222</sup> Id. "Business concerns, organizations, or individuals are affiliates of each other if, directly or indirectly, (a) either one controls or has the power to control the other, or (b) a third party controls or has the power to control both." Id.

<sup>223</sup> See e.g. Gem Const. Co., B-233140, 89-1 CPD ¶ 145 (denying bidder's protest of nonresponsibility determination when bidder's individual sureties were debarred); Ware Window Co., B-233168, 89-1 CPD ¶ 122 (noting that two individual sureties had been proposed for debarment); cf. Major Kevin Chapman, A New Spin On Surety Fraud--Failure To Disclose Bond Obligations, Army Law., Oct. 1992, at 51 (In a case of first impression, the Army recently proposed two individuals for debarment for failure to disclose bond obligations.").

<sup>224</sup> Cf. Turner Lacey, Jr., HUDBCA 93-C-D46, 1994 WL 74946 (upholding five year debarment of fee appraiser and affiliates); Lou Dominick, HUDBCA No. 87-2420-D31, 1987 WL 47421 (reviewing period of debarment for fee appraiser).

<sup>225</sup> FAR 9.403 (affiliate).

<sup>226</sup> FAR 9.406-5 (debarment).

<sup>227</sup> West v. Red Samm Const., 124 F.3d 227 (Fed. Cir. 1997), 1997 WL 488745, at \*2 (affiliate of a debarred subcontractor is not automatically debarred; entitled to due process); cf. Howema

requirements' of due process: adequate notice and a meaningful hearing."<sup>228</sup> The due process afforded these parties is contained at FAR 9.406-3 for debarment and FAR 9.407-3 for suspension actions. Significantly, debarments unsupported by the requisite level of evidence may be overturned.<sup>229</sup>

The suspension and debarment procedures afford a great deal of protection to the government; however, they are not foolproof. First, the factual basis giving rise for grounds to suspend or debar must be brought to the attention of the appropriate agency suspension and debarment official. For example, in Communications by Johnson,<sup>230</sup> the Department of Veterans Affairs (VA) successfully defended its rejection of a bid bond, in part, by establishing that the supporting appraisal was an "unreasonable" estimate of the land's market value and the appraiser had "provided inaccurate, unreliable appraisals in the past . . . ."<sup>231</sup> In a 1994 published opinion, the Comptroller

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Bau-GmbH, B-245356; B-245386, 91-2 CPD ¶ 214, at 2 ("Upon proper written notice and an opportunity to be respond, the suspension may be extended to any named affiliate . . . .").

<sup>228</sup> Commercial Drapery Contractors v. United States, 133 F.3d 1, 6 (D.C. Cir. 1998). However, a suspended contractor is not entitled to greater levels of due process - in this case a formal rather than informal hearing - if the added procedural rights would risk imperiling a related criminal investigation. Id. at 7.

<sup>229</sup> See e.g. Caiola v. Carroll, 851 F.2d 395 (D.C. Cir. 1988) (debarment of president and secretary of debarred company was not supported by a preponderance of the evidence).

<sup>230</sup> B-255478, 94-1 CPD ¶ 163.

<sup>231</sup> Id. at 7.

General determined that "[t]he submitted property appraisal presented by Mr. Hunt appears unreasonable inflated."<sup>232</sup> Despite known problems with this particular appraiser, it was not until September 20, 1995 that Hunt was proposed for debarment, and finally debarred on June 12, 1996.<sup>233</sup> The debarment did not come from the VA; instead it was imposed by a wholly different agency - the Army.

Second, unless the name of a debarred individual appears on documentation contained within a bond package, a contracting officer is unlikely to be placed on notice of the debarred person's involvement with the surety bond. Acting within an organization, such as a surety broker business, debarred individuals can distance themselves from any documentation submitted to the government by using underwriters or other business subordinates, whose names would appear on the documentation. If the organization itself were debarred from further government business, the fraudulent enterprise could escape government detection by simply changing its name, telephone/facsimile numbers and location.

Third, neither surety brokers nor the contractors who use their services are required to disclose the participation of any individual within that brokerage who has been suspended, debarred, convicted of a recent fraud related crime or otherwise

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<sup>232</sup> Id. at 6.

<sup>233</sup> Telephone Interview with Lieutenant Colonel Roger Washington, Army Procurement Fraud Division, June 12, 1998.

operating under a legal cloud. For contracts above the simplified acquisition threshold of \$100,000, the FAR requires contractors to certify that neither the offeror nor its principals are "presently debarred, suspended, proposed for debarment, or declared ineligible for the award of contracts by any Federal agency . . . ." <sup>234</sup> Subcontractors receiving a subcontract in excess of \$25,000 must make a similar written disclosure to the prime contractor. <sup>235</sup>

However, the definition of a principal extends only to those individuals employed by a contractor "having primary management or supervisory responsibilities . . . ." <sup>236</sup> The FAR places no obligation on the contractor to make such certification regarding its surety broker or individual surety. Similarly, the FAR fails to place any certification requirement upon the surety or surety broker.

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<sup>234</sup> FAR 9.409(a) & 52.209-5(a)(1)(i)(A). This FAR provision also requires certification regarding certain convictions, civil judgments, indictments and terminations for default. FAR 52.209-5(a)(1).

<sup>235</sup> FAR 9.409(b), 52.209-6(b). FAR 52.209-6 imposes upon the prime contractor a duty to determine if any of the subcontractor's principals are ineligible to participate in the procurement process. West v. Red Samm Const., 124 F.3d 227 (4th Cir. 1997), 1997 WL 488745, at 3 (debarred). Further, prior to entering into a contract with an ineligible subcontractor, a corporate officer of the prime contractor must first give written notice to the Contracting Officer. FAR 9.405-2(b), 52.209-6(c). Prime contractors may only enter into a subcontract with an ineligible party when a "compelling reason" exists. FAR 9.405-2(b), 52.209-6(a).

<sup>236</sup> FAR 52.209-5(a)(2).

To compound the problem, criminal enforcement mechanisms of suspension or debarment orders are limited. Currently, only two criminal sanctions are associated with the violation of an agency suspension or debarment, but only one of which will have any impact on sureties or surety brokers. First, a violation of the false statement statute, 18 U.S.C. § 1001, is found when a contractor falsely makes a certification, in accordance with FAR 52.209-5, that neither it nor its principals fall into the category of persons or entities ineligible to participate in government contracts.<sup>237</sup> Similarly, the subcontractor's written disclosure to the prime contractor regarding whether the subcontractor or its principals are debarred, suspended or proposed for debarment is subject to the false statement statute.<sup>238</sup> However, because neither an individual surety nor a

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<sup>237</sup> See e.g. United States v. Puente, 982 F.2d 156 (5th Cir.), cert. denied, 508 U.S. 962 (1993) (defendant falsely certified never convicted of a felony); United States v. Schneider, 930 F.2d 555 (7th Cir. 1991) (defendant convicted of falsely certifying he had not been charged with a crime within the past three years.); accord Cox, supra note 1, at 12-13. Indeed, FAR 52.209-5(a)(2) specifically states: "This certification concerns a matter within the jurisdiction of an agency of the United States and the making of a false, fictitious, or fraudulent certification may render the maker subject under section 1001, title 18, United States Code."

<sup>238</sup> This disclosure requirement is contained in FAR 52.209-6. As part of the procurement process the Government may elect to review the statements of eligibility provided by a subcontractor to a prime contractor. See e.g. West v. Red Samm Const., 124 F.3d 227 (4th Cir. 1997), 1997 WL 488745, at \*3 ("with that information the government may investigate further . . . [and] discover additional potential subcontractors to be proposed for debarment."). Even though the subcontractor's statements are made to the prime contractor rather than to the government, such statements are matters within the jurisdiction of the United States, the falsity of which will constitute a



surety broker will be the subject of such a certification, a false statement conviction will never arise.

The second potential sanction arises under section 2F1.1 of the Federal Sentencing Guidelines. Following a criminal conviction, the district court determines the defendant's sentence by calculating a sentence range using the Guidelines. Section 2F1.1 is the guideline provision used for the criminal offenses most commonly associated with individual surety bond fraud cases.<sup>239</sup>

Applying § 2F1.1, a defendant's offense level is increased by two levels for the "violation of any judicial or administrative order, injunction, decree, or process not addressed elsewhere in the guidelines . . . ."<sup>240</sup> This adjustment applies to an individual defendant who controls an entity subject to such restraints, and is aware of the restriction, even if the defendant was not a named party in the prior proceeding.<sup>241</sup> The Guidelines' rationale for the increased level of punishment is that "[a] defendant who has been subject to civil or

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violation of 18 U.S.C. § 1001. See United States v. Frazier, 53 F.3d 1105, 1115 (10th Cir. 1995); cf. United States v. Green, 745 F.2d 1205, 1208-9 (9th Cir. 1985).

<sup>239</sup> Criminal offenses frequently prosecuted in surety fraud cases, and sentenced under § 2F1.1, include false statement (18 U.S.C. § 1001), false bonds (18 U.S.C. § 494), mail fraud (18 U.S.C. § 1341), wire fraud (18 U.S.C. § 1343) and conspiracy (18 U.S.C. § 371). See generally U.S.S.G., App. A.

<sup>240</sup> United States Sentencing Comm'n, Guidelines Manual, § 2F1.1(b)(3)(B) (Nov. 1997) [hereinafter U.S.S.G.].

<sup>241</sup> U.S.S.G. § 2F1.1, cmt. (n.5).

administrative proceedings for the same or similar fraudulent conduct demonstrates aggravated criminal intent and is deserving of additional punishment for not conforming with the requirements of judicial process or orders issued by federal, state, or local administrative agencies."<sup>242</sup>

The courts have applied this sentencing provision in various judicial and administrative contexts. Specifically, section 2F1.1(b)(3)(B) has been applied to bankruptcy proceedings;<sup>243</sup> as well as violations of judicial injunctions,<sup>244</sup> federal probation orders<sup>245</sup> state Supreme Court attorney disbarments,<sup>246</sup>

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<sup>242</sup> U.S.S.G. § 2F1.1, cmt. (backg'd).

<sup>243</sup> United States v. Guthrie, 1998 WL 320328 (6th Cir.), at \*3 & 4 (the majority of circuits have held that a bankruptcy proceeding is a judicial process for purposes of 2F1.1(b)(3)(B)); see also United States v. Messner, 107 F.3d 1448, 1457 (10th Cir. 1997) ("Central to [the] analysis [is] the fact that the defendant had 'sought protection from his [or her] creditors under the shelter of bankruptcy' and then 'abused the bankruptcy process' by concealing assets.") (citation omitted); United States v. Lloyd, 947 F.2d 339, 340 (8th Cir. 1991) ("Lloyd did not violate a specific judicial order, injunction, or decree; however, Lloyd did violate a judicial process by fraudulently concealing assets from bankruptcy officers").

<sup>244</sup> United States v. Gist, 79 F.3d 52 (7th Cir. 1996) (Circuit Court of Cook County, Illinois, enjoined defendant from acting as travel promotor; later convicted of federal offenses arising out of defendant's fraudulent travel promotion business); see also United States v. Merritt, 114 F.3d 1178 (4th Cir. 1997) (Table), 1997 WL 297490, at \*4 n.6 (defendant's fraudulent investment scheme violated prior California court order enjoining defendant from making misleading statements in connection with the sale of real estate).

<sup>245</sup> United States v. Deutsch, 987 F.2d 878, 882 (2d Cir. 1993) (judicial order not to hold himself out as being an attorney.)

<sup>246</sup> United States v. Maurello, 76 F.3d 1304, 1315 (3rd Cir. 1996).

administrative orders from a State insurance commission,<sup>247</sup> and a state court order suspending the defendant's driving privileges.<sup>248</sup>

In contrast, the courts have placed some parameters on the guideline's application. Reasoning that the sentencing provision applies only to violations of orders or processes during the commission of a fraud, the Ninth Circuit has held it inapplicable to the violation of a general bail condition that the defendant commit no crimes.<sup>249</sup> The Second Circuit has held that there must exist some order or command directed specifically at the defendant; an order directed at a generic group is insufficient.<sup>250</sup> Additionally, the Ninth Circuit has held that a

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<sup>247</sup> United States v. Hamrick, 983 F.2d 1069 (6th Cir. 1992) (Table), 1992 WL 380050, at \*1 (defendant convicted of fraudulent investment scheme had violated order from the Tennessee Commissioner of Commerce and Insurance who ordered defendant to "cease and desist 1) selling unregistered securities, 2) acting as an unregistered broker, and using 3) unregistered advertising."); cf. United States v. Christopher, 142 F.3d 46, 47 & 51 n.2 (1st Cir. 1998) (violation of promises to state insurance regulators and a state regulatory order conditioning approval of the acquisition of insurance companies on defendant's assurances that the defendant's company would not use the assets of the acquired companies to finance the acquisition and that preexisting liens would be satisfied prior to closing.).

<sup>248</sup> United States v. Eve, 984 F.2d 701, 703 (6th Cir. 1993).

<sup>249</sup> United States v. Scarano, 975 F.2d 580, 583 (9th Cir. 1992) ("That section adds levels for violation of a judicial order only in the course of committing fraud. No reason comes to mind why violation of a general bail condition should add offense levels for fraud but not for other crimes."). But cf. United States v. Propper, 1994 WL 376083, at \*1 (sentencing provision applies to violation of specific bail condition).

<sup>250</sup> United States v. Carrozzella, 105 F.3d 796, 800 (2d Cir. 1997) (the defendant "violated a command not to file false accounts [with a probate court], but the command was a rule

mere agency warning of a possible violation of the law, without benefit of either a formal order or an adversarial hearing establishing a statutory violation, failed to rise to the level of an "administrative process" within the meaning of § 2F1.1(b)(3)(B).<sup>251</sup>

Although no published decision has addressed this issue in the context of an agency suspension or debarment, the guideline provision should apply to any violation of an agency suspension or debarment order. A formal order is issued by a federal agency pursuant to properly promulgated regulations, the violation of which is not addressed elsewhere in the guidelines. Further, the suspension and debarment mechanism is important to the protection of the integrity of the procurement system because it precludes individuals and entities lacking the requisite level of competence or integrity from participating in the procurement process.<sup>252</sup>

An agency's written notice of suspension or debarment should satisfy the Second Circuit requirement that there be some form of "command or warning" specifically directed at the defendant.<sup>253</sup>

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applicable to all trustees and not specifically directed to him.").

<sup>251</sup> United States v. Linville, 10 F.3d 630 (9th Cir. 1993).

<sup>252</sup> Cf. Messner 107 F.3d at 1457 (recognizing the importance of protecting the integrity of the bankruptcy system when upholding application of § 2F1.1(b)(3)(B)).

<sup>253</sup> United States v. Carrozzella, 105 F.3d 796, 800 (2d Cir. 1997).

Further, that a formal hearing is not required under the FAR<sup>254</sup> does not defeat application of § 2F1.1(b)(3)(B) to violations of agency suspension or debarment orders. For the adjustment to apply, "no formal adversary 'proceeding' is required; an "informal administrative 'process'" will suffice.<sup>255</sup>

Unfortunately, although the application of this guideline provision to the suspension or debarment context would provide a criminal sanction for violating the administrative order after the fraud has been committed, the problem of preventing individual surety bond fraud remains unabated.

In sum, the failure of the suspension and debarment mechanism as a preventative device against fraud stems from the lack of a disclosure requirement. A relatively inexpensive solution to the nondisclosure problem is to require the surety broker, or individual surety if no broker is identified, to

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<sup>254</sup> The FAR provides debarment and suspension proceedings should be "as informal as is practicable, consistent with principles of fundamental fairness." FAR 9.406-3(b)(1); 9.407-3(b). As a minimum, in a suspension action the agency must afford the contractor and its affiliates "an opportunity, following the imposition of suspension, to submit, in person, in writing, or through a representative, information and argument in opposition to the suspension." FAR 9.407-3(b). In a debarment proceeding, the agency must permit "an opportunity to submit, in person, in writing, or through a representative, information and argument in opposition to the proposed debarment." FAR 9.406-3(b)(1). If the debarment action is not based on a conviction or civil judgment, or the suspension action is not based on an indictment, and the contractor's initial submission raises a genuine issue of material fact, the FAR requires a hearing in which the contractor "may appear with counsel, submit documentary evidence, present witnesses, and confront any person the agency presents . . . ." FAR 9.406-3(b)(2); 9.407-3(b)(2).

<sup>255</sup> United States v. Spencer, 129 F.3d 246, 252 (2d Cir. 1997), cert. denied, 118 S.Ct. 1388 (1998).

provide a certificate similar to that required of an offeror, under similar circumstances, but with the definition of "principal" expanded to include any person with a financial interest in the government's use of the surety bond. This certification would place the government on notice of any suspended or debarred individual or entity acting as a middleman between the contractor and individual surety, and facilitate both further government investigation and the contracting officer's responsibility determination. The scope of the certification would reach surety middlemen however defined, to include both individual brokers and individuals employed by a broker company, silent investors in an individual surety bond venture, consultants, agents, representatives, and individuals acting as an attorney-in-fact.

#### **B. Prohibition On Persons Convicted Of Defense Related Felonies**

With some modifications, the Prohibited Employment Act, 10 U.S.C. § 2408, could serve as a quick and effective means of combatting ongoing fraud and inhibiting future fraud in the individual surety bond program. Currently, the Act authorizes a criminal fine of up to \$500,000 to be levied against any defense contractor or subcontractor who knowingly employs, or allows to serve on the board of directors, any felon whose conviction

"arose out of a contract with the Department of Defense."<sup>256</sup>

Further, the Act prohibits such a felon from the following:

(A) Working in a managerial or supervisory capacity on any defense contract or any first tier subcontract of a defense contract.

(B) Serving on the board of directors of any defense contractor or any subcontractor awarded a contract directly by a defense contractor.

(C) Serving as a consultant to any defense contractor or any subcontractor awarded a contract directly by a defense contractor.

(D) Being involved in any other way, as determined under regulations prescribed by the Secretary of Defense, with a defense contract or first tier subcontract of a defense subcontract.<sup>257</sup>

The Defense FAR Supplement further prohibits the felon from serving as an "agent, or representative" of a contractor or first tier subcontractor.<sup>258</sup>

To date, the statute has proved largely unused. Since its enactment in 1986, only a handful of known convictions have occurred under this statute and all have been unreported guilty pleas.<sup>259</sup> The Act's failures stem from the fact that it is too

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<sup>256</sup> 18 U.S.C.A. § 2408(b).

<sup>257</sup> 18 U.S.C.A. § 2408(a).

<sup>258</sup> DFARS 203.570-2(a)(3).

<sup>259</sup> United States v. Gross Metal Products, Inc., No: 2:97 CR 00248-001 (E.D. Pa., filed June 27, 1997) (defense contractor employed a § 2408 felon as consultant on Navy contract); United States v. K.I.M. Aerotech, No. CR-95-101-PHX-PGR (D. Az. filed June 14, 1995) (partnership employed felon/partner on Air Force contract); United States v. Robert Greer, Et. Al., No. CR 4-88-089 (N.D. Tex., filed June 6, 1988) (conspiracy to defraud the United States by conspiring to violate 10 U.S.C. § 2408). In

limited in scope to be effective. First, its prohibitions do not apply to contracts below the simplified acquisition threshold of \$100,000, procurement of commercial items, or to subcontracts for these two categories of contracts.<sup>260</sup>

Second, individuals falling within the Act's orbit are limited to those convicted of (1) felonies, that (2) arise out of contracts with only the Department of Defense.<sup>261</sup> The Act fails to reach those individuals convicted of misdemeanors, convicted of felonies associated with an agency other than the Defense Department, debarred from government procurement activities, and parties found liable in civil fraud actions.

Third, the employment restrictions for applicable felons extend only to defense contractors and first tier subcontractors.<sup>262</sup> The scope of the restrictions do not extend to second tier subcontractors, regardless of the size or dollar value of the procurement. Further, and of significance to this thesis, the Act does not extend to individuals or sureties providing surety bonds to defense contractors.

The easiest modification to the statute's reach could be accomplished by changing the DoD regulations to include, as

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Forman v. Straw, the district court granted summary judgment to the government, denying a felon's "action for declaratory and injunctive relief seeking to prevent the government from asserting 10 U.S.C. § 2408 . . . against him." 1996 WL 729838 (E.D. Pa.).

<sup>260</sup> 18 U.S.C.A. § 2408(a)(4).

<sup>261</sup> 18 U.S.C.A. § 2408(a).

<sup>262</sup> Id.



prohibited felons, individuals employed in a managerial or supervisory capacity by, or acting as, an individual surety bond broker, a term which would be defined broadly. However, a regulatory modification would not address many of the shortcomings identified earlier.

The statute itself should be expanded to reach convictions arising out of a contract with any federal agency. Further, § 2408(a) should be modified so that the scope of the statute would be expanded beyond a defense contract or first tier subcontract, to include any subcontract whose value is above the simplified acquisition threshold. Finally, the DoD regulations should clarify that the term "convicted of fraud or any other felony arising out of a contract" includes convictions associated with individual surety bonds provided on federal contracts, to preclude repeat offenders from participating in the program.

To effectuate the statute's expanded reach, the criminal penalty in § 2408(b) should be expanded. Contractors and subcontractors who knowingly use a § 2408(a) felon as an individual surety, or who knowingly obtain a bond from a broker owned, controlled, managed or supervised by a § 2408(a) felon should also be subject to the criminal penalty provision.

## V. CALCULATION OF LOSS UNDER THE FEDERAL SENTENCING GUIDELINES

### A. Calculating Loss In Surety Bond Fraud Cases

The determination of loss in a surety bond fraud case affects not only a defendant's ultimate sentence, but also the likelihood of prosecution itself. Because the amount of loss will be the single most determining factor when assessing a defendant's likelihood of incarceration,<sup>263</sup> investigators and prosecutors will be hesitant to devote their limited resources in pursuit of a case in which a readily identifiable loss does not exist or when the defendant is unlikely to suffer meaningful punishment.<sup>264</sup> The disincentive to prosecute is particularly strong in cases where a contractor has used worthless individual surety bonds, but otherwise successfully performs on the contract.<sup>265</sup>

Generally, the first step in calculating any defendant's sentence is to determine the base offense level using the

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<sup>263</sup> See United States v. Chorney, 63 F.3d 78, 83 (1st Cir. 1995) ("emphasis on loss, as the main variable in fixing the offense level . . .").

<sup>264</sup> Arsenault Interview, supra note 125; see also Letter from Special Agent Torri K. Piper, Naval Criminal Investigative Service, to the author (Mar. 24 1998) (on file with author) ("If there was not a substantial loss to the government and false documents with witnesses, the U.S. Attorney's Office declined in favor of administrative remedies.");

<sup>265</sup> See Telephone interview with Special Agent Torri K. Piper, Naval Criminal Investigative Service, Jan. 12, 1998 (investigations did not result in prosecution where contractor did not default; feeling of "no harm, no foul."). In such circumstances, without a readily identifiable harm, jury appeal considerations may weigh against prosecution.

Guidelines section applicable to the specific crime of conviction. Using the same section, specific offense characteristics are considered to determine if the offense level - and potential sentence - should be increased. Next, the offense level is adjusted upward or downward depending upon such factors as the defendant's role in the offense, acceptance of responsibility for the misconduct and the vulnerability of the victim.<sup>266</sup> The defendant's criminal history category is then calculated, reflecting any prior criminal convictions.<sup>267</sup> The sentencing guideline range is then determined by locating the point on the Sentencing Table where the offense level and criminal history category meet. If appropriate, the sentencing court may exercise its discretion to depart upward or downward from the guideline range to reflect any unusual circumstances not accounted for in the Guidelines.<sup>268</sup>

For criminal convictions in fraudulent individual surety bond cases, § 2F1.1 of the Federal Sentencing Guidelines is normally the applicable section for calculation of the base level

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<sup>266</sup> See generally, U.S.S.G., chapter 3.

<sup>267</sup> See generally U.S.S.G., chapter 4.

<sup>268</sup> U.S.S.G. at 6 ("The sentencing statute permits a court to depart from a guideline-specified sentence only when it finds 'an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described.'" ) (citing 18 U.S.C. § 3553(b)); see also United States v. Grandmaison, 77 F.3d 555, 559 (1st Cir. 1996) (departures permitted for atypical cases).

and specific offense characteristics.<sup>269</sup> Using this section, a defendant convicted of a false statement - a common criminal charge in individual surety bond fraud cases - would begin with a base offense level of six.<sup>270</sup> Once the loss associated with the misconduct exceeds \$2,000, the offense level increases in relation to the amount of proven loss.<sup>271</sup> A defendant's offense level may increase as much as 18 levels as a result of calculated loss, plus additional increases for such offense characteristics as "more than minimal planning" and falsely representing that the defendant acted on behalf of a government agency.<sup>272</sup> As discussed earlier, conduct violative of an agency suspension or debarment should result in an additional two level increase.<sup>273</sup>

Unfortunately, "loss" is not always easily defined and is often difficult to calculate.<sup>274</sup> Recognizing the difficulties associated with determining both the existence and quantum of

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<sup>269</sup> See e.g. United States v. Leahy, 82 F.3d 624, 638 (5th Cir. 1996); United States v. West, 2 F.3d 66, 68 (4th Cir. 1993); see also note 239, supra (criminal statutes commonly associated with individual surety bond fraud sentenced under § 2F1.1). Appendix A of the Guidelines indicates applicable guideline provisions by specific criminal statute.

<sup>270</sup> U.S.S.G. § 2F1.1(a).

<sup>271</sup> U.S.S.G. § 2F1.1(b)(1); see also United States v. Barnes, 125 F.3d 1287, 1290 (9th Cir. 1997) ("The Guidelines increase this level incrementally based upon the amount of monetary loss attributable to the fraud.").

<sup>272</sup> U.S.S.G. § 2F1.1(b)(1) & (2).

<sup>273</sup> U.S.S.G. § 2F1.1(b)(3); see notes 239-255 supra and accompanying text.

<sup>274</sup> United States v. Harper, 32 F.3d 1387, 1389 (9th Cir. 1994) ("the concept of 'loss' is not self-defining.").

loss, the Guidelines do not require that loss be "determined with precision."<sup>275</sup> A court satisfies its sentencing obligations when it makes "a reasonable estimate of the loss, given the available information."<sup>276</sup>

If the amount of loss is in dispute, the Government must prove quantum by a preponderance of the evidence.<sup>277</sup> Prosecutors may not rely on mere speculation.<sup>278</sup> Further, with the possible exception of defense contracts, loss attributable to the defendant must actually be shown to have been directly caused by the fraudulent activity.<sup>279</sup> With respect to defense contract

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<sup>275</sup> U.S.S.G. § 2F1.1, cmt. (n.8); United States v. Whatley, 133 F.3d 601, 606 (8th Cir. 1997); Harper, 32 F.3d at 1389.

<sup>276</sup> U.S.S.G. § 2F1.1, cmt. (n.8); see also United States v. Kelley, 76 F.3d 436, 439-40 (1st Cir. 1996); United States v. McAlpine, 32 F.3d 484, 488 (10th Cir. 1994).

<sup>277</sup> United States v. Wells, 127 F.3d 739, 745 (8th Cir. 1997); United States v. Barnes, 125 F.3d 1287, 1290 (9th Cir. 1997); United States v. McAlpine, 32 F.3d 484, 487 (10th Cir. 1994); see Deborah Young, Fact-Finding At Federal Sentencing: Why The Guidelines Should Meet The Rules, 79 Cornell L. Rev. 299, 335 (1994) (all federal courts of appeal have determined that "the appropriate standard of proof for resolving factual disputes at guidelines sentencing is a preponderance of the evidence.")

<sup>278</sup> Barnes, 125 F.3d at 1290 ("mere speculation is insufficient.").

<sup>279</sup> United States v. Daddona, 34 F.3d 163, 170 (3rd Cir.), cert. denied 115 S.Ct. 515 (1994) (insufficient evidence to establish that loss associated with cost to complete project was caused by fraud rather than caused by failure of contractors to timely perform). But cf. United States v. Morris, 80 F.3d 1151, 1171-2 (7th Cir. 1996) (rejecting argument that intervening causes should reduce loss when defendant's conduct placed victim at risk in the first instance). In an unusual case, the contractor was convicted of providing false certifications to the Navy with its progress payment requests, wrongly attesting to having paid its suppliers, but the misconduct was discovered after the government terminated the contract for convenience.

awards affected by fraudulent bonds, the Guidelines permit the inclusion of reasonably foreseeable consequential damages.<sup>280</sup>

The Guidelines offer alternative methods of determining loss. In fraud cases, the Guidelines favor using the "actual loss to the victim" unless the defendant's intended loss was greater, in which case intended loss is used.<sup>281</sup> Additionally, actual loss calculations should be used even when that loss is larger than the loss intended or foreseen by the defendant.<sup>282</sup> The Guidelines posit that measuring loss to the victim by examining

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The court determined that the resultant losses experienced by the defendant's suppliers and surety bond company were civil matters not attributable to the defendant's criminal misconduct. United States v. Apex Roofing Of Tallahassee, 49 F.3d 1509, 1514 n.12 (11th Cir. 1995)

<sup>280</sup> In cases affecting the award of defense contracts, the Guidelines contemplate the inclusion of consequential damages as part of the loss calculation, so long as these indirect losses were reasonably foreseeable. U.S.S.G. § 2F1.1, cmt. (n.7(c)); accord United States v. Leahy, 82 F.3d 624, 638 (5th Cir. 1996).

<sup>281</sup> U.S.S.G. § 2F1.1, cmt. (n.7(c)); see also United States v. Bald, 132 F.3d 1414, 1416 (11th Cir. 1998) (greater of the two); United States v. Wells, 127 F.3d 739 (8th Cir. 1997) ("Loss' under the guidelines is the greater of the intended loss or the actual loss."); United States v. Lorenzo, 995 F.2d 1448, 1460 (9th Cir.), cert. denied, 114 S.Ct. 225 (1993). The amount of intended loss is not dependent upon it being "realistic." Lorenzo, 995 F.2d at 1460; United States v. Koenig, 952 F.2d 267, 272 (9th Cir. 1991). However, an extremely low probability of success in carrying out the fraud may be grounds for a downward departure from the Guidelines. United States v. Bonanno, \_\_\_ F.3d \_\_\_ (7th Cir. 1998), 1998 WL 309085, at \*7.

<sup>282</sup> United States v. Sarno, 73 F.3d 1470, 1500 (9th Cir. 1995).

the defendant's gain is disfavored because such gain "ordinarily will underestimate the loss."<sup>283</sup>

In addition, for purposes of loss tabulation, a defendant "is responsible for the reasonably foreseeable conduct of his co-conspirators in furtherance of the execution of their jointly undertaken criminal activity."<sup>284</sup> When making its loss calculation, the sentencing court may base its decision on evidence presented against co-defendants.<sup>285</sup>

Finally, the Guidelines provide for an upward departure when the calculated loss "does not fully capture the harmfulness and seriousness of the conduct . . . ." and a downward departure when calculated loss "overstate[s] the seriousness of the offense."<sup>286</sup> Particular to § 2F1.1, the Guidelines' commentary provides that a sentencing court may depart upward or downward when the calculated loss "significantly understates or overstates the seriousness of the defendant's conduct . . . ."<sup>287</sup> The

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<sup>283</sup> U.S.S.G. § 2F1.1, cmt. (n.8). This method of determining the amount of loss should be used only "when more precise means of measuring loss are unavailable." United States v. Anderson, 45 F.3d 217, 221 (7th Cir. 1995).

<sup>284</sup> United States v. Lorenzo, 995 F.2d 1448, 1460 (9th Cir. 1993); see also United States v. Whatley, 133 F.3d 601, 606-7 (8th Cir. 1997).

<sup>285</sup> Lozenzo, 995 F.2d at 1460; cf. United States v. Earles, 955 F.2d 1175, 1180 (8th Cir. 1992).

<sup>286</sup> U.S.S.G. § 2F1.1, cmt. (n.10).

<sup>287</sup> U.S.S.G. § 2F1.1, cmt. (n.7(b)); see also U.S.S.G. § 2F1.1, cmt. (n.10) (examples of situations in which a departure may be warranted); see e.g. United States v. Jackson, 798 F. Supp. 556 (D. Minn. 1992) (downward departure granted to defendant who prepared a false real estate appraisal).

prosecution bears the burden of proving entitlement to an upward adjustment by a preponderance of the evidence.<sup>288</sup>

#### **B. Relationship Between Civil/Administrative Loss And Criminal Loss Determinations**

When defining or quantifying loss for guideline purposes in the surety bond fraud context, courts should be able to consider how loss is determined in the noncriminal context.<sup>289</sup> Cases determining damage to the United States under the Contract Disputes Act of 1978<sup>290</sup> for default terminations should prove particularly illuminating.

To illustrate, when a contractor is terminated for default because it provided defective or fraudulent surety bonds to the United States, the resultant damages should mirror in many respects the loss calculated under the Guidelines. In both scenarios the victim - by which the loss or damages is primarily gauged - is the United States government. Both bodies of law embrace the notion of fundamental fairness to the civil/criminal defendant, and take into consideration similar items of damage,

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<sup>288</sup> United States v. Barnes, 125 F.3d 1287, 1290 (9th Cir. 1997).

<sup>289</sup> See United States v. Gennuso, 967 F.2d 1460, 1462 (10th Cir. 1992) ("helpful to refer to the two methods most commonly used to compute civil damages for fraud" when determining actual net loss under Guidelines).

<sup>290</sup> 41 U.S.C. §§ 601 et. seq.



such as excess costs of reprocurement<sup>291</sup> or completion costs,<sup>292</sup>  
associated administrative costs<sup>293</sup> and actual damages.<sup>294</sup>

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<sup>291</sup> Compare United States v. Hunt, CR-95-299-1-PHX-RCB (D. Ariz. Apr. 8, 1996 ((Sentencing), affirmed, No. 96-10181 (9th Cir. filed Mar. 14, 1997), cert. denied, 118 S.Ct. 130 (1997) (loss includes difference in original lowest bidder's price and ultimate contract award price); United States v. Joseph, 921 F.2d 282 (9th Cir. 1990) (Table), 1990 WL 212677 at \* 3, cert. denied, 499 U.S. 929 (1991) ("reprocurement costs and other costs associated with the . . . contract default" included in loss calculation under Guidelines) with Glenn's Heating, ASBCA No. 32723, 87-1 BCA ¶ 19,355 (right to excess reprocurement costs when contractor terminated for default for failing to provide proper performance and payment bonds). Under the CDA, excess costs of reprocurement are the "difference between what the Government would have paid under the original, defaulted contract, and what it did pay to the reprocurement contractor." American Kal Enterprises, GSBCA No. 4987, 80-2 BCA ¶ 14,522, at 71,567; see also Cascade Pacific International v. United States, 773 F.2d 287, 293 (Fed. Cir. 1985).

<sup>292</sup> Compare Leahy, 82 F.3d at 638 (cost of additional materials required to complete roofing contract included in sentencing loss calculation for defendant who provided false surety bonds) with Ronald L. Collier d/b/a Carolina Maint. Co., ASBCA No. 26972, 89-1 BCA ¶ 21,328 (defaulted contractor liable for completion costs); Thomas F. Williamson and Scott L. Medill-Jones, "Government Damages For Default," Briefing Papers No. 89-7, at 2 (June 1989) (under CDA, defaulting contractor liable "for any additional costs of reprocurement or completion above the contract price originally agreed to, unless the default is excused.").

<sup>293</sup> Compare United States v. Stein, 13 F.3d 489 (1st Cir. 1994) (\$250 administrative costs included in sentencing loss calculation under Guidelines), with Mega Const. Co. v. United States, 29 Fed. Cl. 396, 501 (1993) (government entitled to recover from defaulted contractor the administrative costs incurred awarding and administering reprocurement contract).

<sup>294</sup> Compare Leahy, 82 F.3d at 638 (physical damage included as loss under Guidelines) with Williamson & Medill-Jones, supra note 292, at 2 (may recover actual damages).

All federal contracts have a termination for default clause.<sup>295</sup> The purpose of a default clause is to provide a method of determining damages to the government upon contractor default.<sup>296</sup> Traditionally, the amount of damages associated with a defaulted contract has been the difference between the repurchase price and the original contract price.<sup>297</sup> However, the default clauses are not the government's exclusive remedy. Indeed, the standard default clauses provide that "[t]he rights and remedies of the Government in this clause are in addition to any other rights and remedies provided by law or under this contract."<sup>298</sup> The government may also seek any actual

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<sup>295</sup> The default clause is located at FAR 52.249-8 for fixed-price supply and service contracts, in FAR 52.249-10 for fixed-price construction contracts, and in FAR 52.249-6 for cost-reimbursement contracts. John Cibinic, Jr. and Ralph C. Nash Jr., *Administration Of Government Contracts* 901 (3rd ed. 1995).

<sup>296</sup> Eldon H. Crowell and W. Stanfield Johnson, "Excess Repurchase Costs," Briefing Papers No. 67-6, at 2 (Dec. 1967).

<sup>297</sup> Williamson and Medill-Jones, *supra* note 292, at 3 ("As a most basic rule, the measure of damages recoverable under the 'Default' clause is the **reasonable repurchase price** . . . less the **original contract price**.") (emphasis in original); Crowell and Johnson, *supra* note 296, at 2 ("This measure is, generally, the **difference** between (a) the price under **your defaulted** contract and (b) the price the Govt had to pay in **repurchasing** the item from another source.") (emphasis in original); *see also* American Kal Enterprises, GSBGA No. 4987, 80-2 BCA ¶ 14,522, at 71,567 ("difference between what the Government would have paid under the original, defaulted contract, and what it did pay to the repurchase contractor."); *accord*, Meyer Labs, ASBCA No. 19525, 87-2 BCA ¶ 19,810.

<sup>298</sup> FAR 52.249-7 (Fixed Price Architect-Engineer); 52-249-8(h) (Fixed-Price Supply and Service); 52.249-9(h) (Fixed-Price Research and Development); 52.249-10(d) (Fixed-Price Construction); *see also* FAR 49.402-7(b) ("other ascertainable damages"). However, one recognized limitation on the

or common law damages.<sup>299</sup> In short, under the CDA the government's damages include all reasonable and foreseeable out-of-pocket expenses associated with the default.

Similarly, actual loss under the Guidelines reflects "the amount of money the victim has actually ended up losing at the time of sentencing . . . ." <sup>300</sup> Actual loss is limited to the net loss directly attributed to the defendant's fraudulent misconduct.<sup>301</sup>

### C. Criminal Court Treatment As "Loss" Of Selected Items

#### 1. Surety Fees

When a contractor purchases a bond, it pays the surety or surety broker a fee or premium. The fee for a bid bond is a fixed price, ranging from approximately \$150-300.<sup>302</sup> The fee for performance and payment bonds are a percentage of the contract's

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government's recovery of damages is that it may not recover both liquidated and actual damages. Cargill, AGBCA No. 84-164-1, 88-3 BCA ¶ 21,064.

<sup>299</sup> Nash & Cibinic, supra note 295, at 998 (actual damages) & 1045 (common law damages).

<sup>300</sup> United States v. Haddock, 12 F.3d 950, 961 (10th Cir. 1993) (citation omitted). "A court should measure actual loss by 'how much better off the victim would be but for the defendant's fraud.'" Id.

<sup>301</sup> Id.

<sup>302</sup> Arsenault Interview, supra note 125 (the more bonds bought, the cheaper they were).

value, usually 3-5%.<sup>303</sup> However, although the contractor initially pays for the bond, the cost is ultimately passed on to the government.<sup>304</sup> In a fixed price contract, the bond cost would be included in the contract price,<sup>305</sup> which is paid by the government at the end of contract performance or during performance through progress payments.<sup>306</sup> For cost-reimbursement

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<sup>303</sup> United States v. West, 2 F.3d 66, 67 (4th Cir. 1993) ("The typical fee for providing the bonds was 3-5% of the contract price."); see also Arsenault Interview, supra note 125 (3-5%); cf. John Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967 ("as high as 7%").

<sup>304</sup> United States v. Merklinger, 16 F.3d 670, 671 (6th Cir. 1994) ("Because the surety fee is included as part of the contractor's bid, the surety fee is actually paid by the government."); John Emshwiller, Wide Federal Contract Fraud Is Probed, Wall St. J., Feb. 15, 1989, 1989 WL-WSJ 481967 ("contractors pass along such extra costs to the government."); GAO Fact Sheet, supra note 3, at 29 (Government "generally reimburses the contractor for the premium paid for the performance and payment bonds."); cf. Lane Const. Co., ENG BCA 5880, 93-1 BCA ¶ 25,448 (discussion of agency's obligation to reimburse contractor for bond premiums).

In some cases the contractor may be defaulted before it has been reimbursed for any bond premiums. Assuming arguendo that the contractor, rather than the government, is viewed as the victim, the legal analysis would not be affected because the Guidelines do not require the identification of a specific victim when calculating loss. United States v. Resurrection, 978 F.2d 759, 762 (1st Cir. 1992).

<sup>305</sup> Cf. Payment Bond Manual, supra note 47, at 2 (cost of bond usually included in contract price).

<sup>306</sup> See e.g. United States v. Leahy, 82 F.3d 624, 628 (5th Cir. 1996) (invoice for bond submitted with request for progress payment); see also FAR 52.232-5(g) ("In making these progress payments [in a fixed price construction contract], the Government shall, upon request, reimburse the Contractor for the amount of premiums paid for performance and payment bonds . . . after the Contractor has furnished evidence of full payment to the surety.").

contracts, the cost principles specifically provide for the allowability of bonding costs.<sup>307</sup>

Generally, the courts have recognized a loss for purposes of the Guidelines when the victims "paid for something they did not get . . . ." <sup>308</sup> The rationale for this calculation of loss is that it reflects the "actual economic value of that which [the defendant] obtained from his various victims." <sup>309</sup> Of all the potential forms of loss associated with surety bond fraud, surety fees are the simplest to calculate and the easiest to apply to the guidelines. The amount paid in surety fees represents in part the victim's actual loss because it directly reflects out-of-pocket expenses; the defendant's intended loss because the specific fee is usually dictated by the surety or surety broker; and the defendant's gain because the surety fee is the actual amount the defendant receives for providing fraudulent surety bonds.

Courts addressing this issue have included surety fees within the calculation of loss.<sup>310</sup> To illustrate, in United

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<sup>307</sup> FAR 31.205-4

<sup>308</sup> United States v. Harper, 32 F.3d 1387, 1392 (9th Cir. 1994) (defendants collected rent on mortgaged property acquired fraudulently until lenders foreclosed and evicted renters); United States v. Loscalzo, 18 F.3d 374, 386 (7th Cir. 1994) (fraudulently obtaining minority set-aside contract).

<sup>309</sup> Harper, 32 F.3d at 1393.

<sup>310</sup> United States v. Leahy, 82 F.3d 624, 638 (5th Cir. 1996) (\$55,000 in false bond premiums included in loss calculation); United States v. Hunt, CR-95-299-1-PHX-RCB (D. Ariz. Apr. 8, 1996) (Sentencing transcript at 38) (bond premiums included), affirmed, No. 96-10181 (9th Cir. filed Mar. 14, 1997), cert.

States v. West,<sup>311</sup> the defendant surety brokers received \$2.9 million in broker fees from government contractors for surety bonds using false Affidavits of Individual Surety on contracts valued at "tens of millions of dollars."<sup>312</sup> However, of the \$2.9 million, loss calculated in terms of defaulted or "belly-up" contractors fell below \$2,000,000.<sup>313</sup> Affirming the district court's decision, the United States Court of Appeals for the Fourth Circuit agreed that the loss calculation should include the amount of surety bond fees paid on nondefaulting contracts, viewing the entire \$2.9 million in broker fees as an actual loss to the government under the rationale that "the government simply did not get what it paid for . . . ."<sup>314</sup>

## **2. Administrative Costs**

Under The Contract Disputes Act, when a contractor is terminated for default the government may recover the administrative costs of reprocurement as common law damages.<sup>315</sup>

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denied, 118 S.Ct. 130 (1997).

<sup>311</sup> 2 F.3d 66 (4th Cir. 1993).

<sup>312</sup> Id. at 71.

<sup>313</sup> Id.

<sup>314</sup> Id.; accord Hunt, CR-95-299-1-PHX-RCB (D. Ariz. Apr. 8, 1996 (contracts not defaulted)).

<sup>315</sup> Mega Const. Co. v. United States, 29 Fed. Cl. 396, 501 (1993); Jeff Talano, PSBCA No. 3695, 97-1 BCA ¶ 28,628, at 142,937; Arctic Corner, ASBCA No. 38075, 94-1 BCA ¶ 26,317, at 130,905; Birken Manu. Co., ASBCA No. 32590, 90-2 BCA ¶ 22,845; see also Cibinic and Nash, supra note 295, at 1045 ("right to

Examples of recoverable costs include expenses associated with soliciting bids from qualified contractors for a reprocurement contract and then awarding the contract;<sup>316</sup> the expense of administering a reprocurement contract;<sup>317</sup> and reasonably foreseeable design, inspection, travel and testing expenses.<sup>318</sup>

The inclusion of administrative reprocurement costs within the loss calculation for sentencing purposes is supported by both relevant case law and the Federal Sentencing Guidelines. When a contractor has been defaulted as a result of defective bonding, courts have included administrative costs associated with reprocurring the contract as a loss to the government.<sup>319</sup> Additionally, these administrative costs may also serve as the basis for restitution.<sup>320</sup>

Similarly, the Guidelines' Commentary provides for the inclusion of foreseeable administrative reprocurement costs in

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collect certain 'administrative costs' incurred by the agency in connection with the reprocurement contract.") (citing Airways Corp. v. United States, 230 Ct.Cl. 47, 673 F.2d 368 (1982)).

<sup>316</sup> Jeff Talano, PSBCA No. 3695, 97-1 BCA ¶ 28,628, at 142,937.

<sup>317</sup> Mega Const. Co., 29 Fed. Cl. at 501.

<sup>318</sup> Id.; Tester Corp. v. United States, 1 Cl. Ct. 370, 377-8 (1992).

<sup>319</sup> United States v. Stein, 13 F.3d 489 (1st Cir. 1994) (false performance and payment bonds); see United States v. Schneider, 930 F.2d 555, 557-8 (7th Cir. 1991) (recognizing as a legitimate form of loss in a fraudulent surety bond case the "incurred expenses in terminating the contract or in obtaining a substitute contract.").

<sup>320</sup> Stein, 13 F.3d at 498.

the loss calculation, at least with respect to the award phase of a defense procurement. Specifically, Application Note 7(c) states that "in the case of fraud affecting defense contract award, loss includes the reasonably foreseeable administrative cost to the government and other participants of repeating or correcting the procurement affected, plus any increased cost to procure the product or service involved that was reasonably foreseeable."<sup>321</sup>

### 3. Difference In Bid Amounts

When a contractor, who is the lowest bidder in a sealed bid procurement, submits a defective bid bond, the offer is rejected as nonresponsive and the government must then award the contract to the next lowest responsive, responsible bidder.<sup>322</sup> Similarly, if documentation provided in support of the bid bond indicates that the individual surety is not responsible, the contractor may be rejected on that basis.<sup>323</sup> In both cases, the difference

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<sup>321</sup> U.S.S.G. § 2F1.1, cmt. (n. 7(c)).

<sup>322</sup> See e.g. Jay-Brant Gen. Contractors, B-274986, 97-1 CPD ¶ 17 (low bidder rejected as nonresponsive and award made to next lowest bidder); R.P. Richards, Inc., B-272430, 96-2 CPD ¶ 138 (same); Bednar, supra note 67, at 89 ("If the low bidder is disqualified as nonresponsive, the next bidder in line stands to receive the award at a higher price."); cf. Brothers Const. Co., B-278042, 97-2 CPD ¶ 135, at 2 ("when a bid includes a defective bond, the bid itself is rendered defective and must be rejected as nonresponsive.").

<sup>323</sup> See e.g. Enclave One, B-232383, 88-2 CPD ¶ 488, at 3 ("Enclave was therefore found to be nonresponsive based upon the unacceptability of its individual sureties and its bid was rejected."); cf. Gene Quigley, Jr., B-241565, 91-1 CPD ¶ 182



between the two bid prices is a cost to the government that would not have existed but for the defective surety bond causing the nonresponsiveness determination of the lowest bidder.

Similarly, after award if the contractor's bonds prove defective, that contractor may be terminated for default<sup>324</sup> and the government may reprocure the contract to another contractor.<sup>325</sup> For purposes of sentencing guidelines loss calculation, the difference between the original contractor's bid price and that of the eventual awardee should be viewed as a loss to the victim-government. Support for this position is found within CDA caselaw.<sup>326</sup>

Unfortunately, under the sentencing guidelines no consensus of opinion has emerged. The few courts to address this issue

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(supporting documentation includes the SF 28, certificate of title and pledge of assets).

<sup>324</sup> Ruffin's A-1 Contracting, ASBCA No. 38343, 90-3 BCA ¶ 23,243, at 116,626 ("failure to submit acceptable surety bonds justifies default termination . . . ."); Dry Roof Corp., ASBCA No. 29061, 88-3 BCA ¶ 21,096, at 106,505 (submission of forged individual performance and payment bonds warrants a default termination.)

<sup>325</sup> See e.g. Glenn's Heating, ASBCA No. 32723, 87-1 BCA ¶ 19,355 (contract reprocured to next lowest bidder when performance and payment bonds proved defective).

<sup>326</sup> Helm, supra note 17, at 21 n.5 ("The contractor is liable for the difference in price between its bid and the bid that the government ultimately accepts to procure the same work. The contractor is also liable for the administrative costs of the reprocurement."); cf. Auto Skate Co., GSBCEA No. 10510, 91-3 BCA ¶ 24,260 (contractor terminated for default for failing to meet delivery schedule liable for higher price paid to reprocurement contractor for same goods).

have not decided it uniformly. In United States v. Schneider,<sup>327</sup> the defendants, a husband and wife conspiracy, submitted fraudulent performance and payment bonds to federal agencies in order to obtain various contracts. Mrs. Schneider submitted the bonds with her bid, but the agency rejected the bid because of her bonds-albeit unaware of the fraud-and ultimately accepted a higher bidder's offer.<sup>328</sup> Mr. Schneider, a building contractor, was awarded a construction contract as the low bidder, but the agency terminated it after learning that the bonds were false and reawarded to a higher bidder.<sup>329</sup> Both defendants were convicted of crimes associated with both frauds.<sup>330</sup>

The district court calculated loss for Mrs. Schneider by adding the amount of defendants' two bids;<sup>331</sup> but for Mr. Schneider the judge used the differences in contract price between the Schneiders' bids and the actual award price.<sup>332</sup> On appeal, the government elected not to defend the inexplicable difference in sentencing between the conspirators, but instead

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<sup>327</sup> 930 F.2d 555 (7th Cir. 1991).

<sup>328</sup> Id. at 557. The opinion does not indicate why Mrs. Schneider's bond was initially rejected, only indicating that the agency was "unsatisfied" with it. Id.

<sup>329</sup> Id. at 556-7.

<sup>330</sup> Id. at 557.

<sup>331</sup> The opinion does not explain the sentencing court's rationale for this loss calculation, which the appellate court ultimately rejected as unreasonable. Id.

<sup>332</sup> Id. The government characterized the difference in bid prices as the "'excess procurement cost.'" Id.

posited that the sentencing court's determination of loss as reflected in Mrs. Schneider's sentence was the proper means of loss calculation.<sup>333</sup>

The United States Court of Appeals for the Seventh Circuit vacated the sentences. With respect to Mrs. Schneider, the court rejected bid price by itself as a measure of loss when, as here, "the contract is terminated before that other party--the intended victim of the fraud--has paid a dime."<sup>334</sup> Writing for the court, Judge Posner hypothesized that under such circumstances loss could be determined by measuring the costs associated with terminating and reprocurring the contract.<sup>335</sup> Additionally, loss could include the difference in contract prices if the delay associated with the termination and reprourement of the contract required the government to pay a higher price because of adverse market conditions.<sup>336</sup>

With respect to Mr. Schneider's loss calculation, the court distinguished between two types of fraud. First, when the defendant intends to keep the entire contract price without rendering any service, the measure of "expected loss" is the contract price itself.<sup>337</sup> Second, a less egregious form of fraud

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<sup>333</sup> Id. This method reflected a higher offense level. Id.

<sup>334</sup> Id.

<sup>335</sup> Id. at 557-8.

<sup>336</sup> Id. at 558.

<sup>337</sup> Id.

is committed when, as here, the contract is obtained by fraud, but the contractor is willing and able to perform.<sup>338</sup>

Under such circumstances, the calculated loss must bear some measure of economic reality.<sup>339</sup> However, because the government failed to quantify the risk posed to the government by the fraudulent bonds, or to otherwise present evidence of loss, the court vacated the sentence and remanded the case for resentencing.<sup>340</sup>

In United States v. Stern<sup>341</sup> the Air Force awarded a renovation contract to a contractor who had submitted the lowest bid for the work. The defendants had submitted a worthless bid bond with the offer.<sup>342</sup> After contract award, the defendants submitted counterfeit performance and payment bonds, bearing the contractor's seal and the signatures of the contractor's president and a business associate.<sup>343</sup> Eventually, the Air Force detected the fraud, terminated the contract, and awarded the

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<sup>338</sup> Id.

<sup>339</sup> Id. at 559.

<sup>340</sup> Id. at 559. As potential sources of loss the court suggested the government's "expenses of recontracting" and the contractor's unlawfully obtained profit. Id. at 558. When calculating loss, the court should consider the value of legitimate services provided by the defendant. United States v. Sublett, 124 F.3d 693, 695 (5th Cir. 1997).

<sup>341</sup> 13 F.3d 489 (1st Cir. 1994)

<sup>342</sup> Id. at 492. The bid bond was by a company that was neither listed on Treasury Circular 570 nor possessed any assets. Id. Initially, the Air Force failed to detect the problem. Id.

<sup>343</sup> Id.

reprocurement to the next lowest bidder.<sup>344</sup> When calculating the specific offense characteristic under § 2F1.1 of the guidelines, the district court based its loss calculation upon the difference between the defendant/contractor's bid price and the contract award amount paid to the second lowest bidder.<sup>345</sup>

Disfavoring the establishment of bright line rules for loss calculations in fact driven sentencing determinations, the United States Court of Appeals for the First Circuit rejected the mechanical calculation of loss based upon the differences in contract bid amounts, within the same procurement action, absent proof that the government "could have secured a bid from a properly bonded contractor at the price offered by [the defendant]." <sup>346</sup> The court was unwilling to accept a "but for" theory of loss without the government first establishing that the defendant's company was (1) capable of securing a legitimate surety bond, (2) at the same low bid price.<sup>347</sup> Significantly, the court was willing to consider as loss "a general increase" in the price of contract bid prices during a subsequent round of offers, as measured by the first-round lowest--and tainted-- bid and the second round lowest bid.<sup>348</sup>

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<sup>344</sup> Id. The contract was awarded without rebidding. Id.

<sup>345</sup> Id. at 495.

<sup>346</sup> Id. at 496-7.

<sup>347</sup> Id. at 497 n.7.

<sup>348</sup> "On certain facts--say, a general increase in the level of second round bids after a rebidding due to fraud--a calculation of loss based on the differential between a tainted

Conversely, in United States v. Hunt,<sup>349</sup> the defense argued that loss was too speculative to calculate because there was no evidence presented that the lowest bidders could actually have obtained legitimate surety bonds.<sup>350</sup> Indeed, the defense posited that the defendant should be credited for any savings the government obtained as a result of contracts being awarded to low bidders, who would not have obtained the contracts but for the use of the fraudulent surety bonds.<sup>351</sup>

The sentencing court rejected the defense argument. Characterizing the difference in contract prices as a "true loss," the court opined that whether or not the lowest bidder was able to obtain legitimate bonding from an alternative source "begs the question."<sup>352</sup> The court found that the difference in price between the lowest and next lowest bidder was "an actual loss to the Government."<sup>353</sup>

In an unpublished decision, the United States Court of Appeals for the Ninth Circuit affirmed Hunt's conviction and

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first-round best bid and a higher second-round best bid might be entirely persuasive." Id. at 497.

<sup>349</sup> CR-95-299-1-PHX-RCB (D. Ariz. Apr. 8, 1996) (Sentencing), affirmed, No. 96-10181 (9th Cir. filed Mar. 14, 1997), cert. denied, 118 S.Ct. 130 (1997).

<sup>350</sup> Hunt, Sentencing Transcript at 14.

<sup>351</sup> Id. at 13-14. Cf. Schneider, 930 F.2d at 558 (such an offset is not permitted).

<sup>352</sup> Hunt, Sentencing Transcript at 37.

<sup>353</sup> Id.

sentence.<sup>354</sup> The Ninth Circuit rejected the defendant's argument that the government suffered no actual loss and pointed out that U.S.S.G. § 2F1.1 required the sentencing court "to take into account the cumulative loss produced by a common scheme or course of conduct."<sup>355</sup> This amount need not be precise, the court needed only to make a reasonable estimate of the loss amount.<sup>356</sup>

Significantly, the Ninth Circuit held that the sentencing judge did not err in using the difference in bids as a measure of loss to the government.<sup>357</sup> Reviewing the evidence before it, the court opined:

Here, agent Arsenault testified that the Navy rejected two of the lowest bids on certain Navy contracts because they could not substantiate Hunt's appraisal of the value of the property securing those bids. Agent Arsenault further testified that, because these bids were rejected, the Navy contracted with the next highest bidder. The evidence established that the next highest bidder was \$121,000 more than the bids which were rejected because of Hunt's appraisals. Because the Navy paid \$121,000 more than it would have but for Hunt's appraisal, the district court did not err by using this amount to calculate Hunt's base offense level.<sup>358</sup>

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<sup>354</sup> United States v. Hunt, No. 96-10181 (9th Cir. filed Mar. 14, 1997), cert. denied, 118 S.Ct. 130 (1997).

<sup>355</sup> Id. at 8 (citing United States v. Niven, 952 F.2d 289, 291 (9th Cir. 1991) (per curiam)).

<sup>356</sup> Id.

<sup>357</sup> Id. (citing United States v. Conkins, 9 F.3d 1377, 1384 (9th Cir. 1993)).

<sup>358</sup> Id. at 8.

Generally, actual loss may be measured by the relative position of the government "but for" the fraudulent bonds.<sup>359</sup> The analysis applied in determining loss under the guidelines should depend upon the type of false bond provided and the stage of the procurement when the fraud is discovered.

In a sealed bid procurement, but for a false bid bond, the government would have obtained the benefit of receiving the lowest offer. Prior to contract award, when the lowest offeror is declared nonresponsive because of the defective bid bond, the government must award to the second lowest bidder to obtain the same services-at a higher price. Even if the lowest bidder could have obtained a legitimate surety bond, the contractor remains nonresponsive and cannot receive the award.<sup>360</sup> After contract award, in negotiated or sealed bid procurement, but for a contractor being defaulted because it provided fraudulent performance and payment bonds, the government would not have been required to incur additional costs associated with reprocurring or completing the contract.

As a preliminary matter, the holdings of Hunt and Stern may be distinguished on their facts. The court in Hunt dealt

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<sup>359</sup> United States v. Haddock, 12 F.3d 950, 961 (10th Cir. 1993) ("A court should measure actual loss by 'how much better off the victim would be but for the defendant's fraud.'") (citing United States v. Kopp, 951 F.2d 521, 531 (3rd Cir. 1991)).

<sup>360</sup> See Electrical Generation Tech., B-235809, 89-2 CPD ¶ 204, at 5 ("In any event, EGT would not be entitled to substitute sureties after bid opening since such a substitution would alter the joint and several liability of the sureties under the bid bond, which is the principal factor in determining the responsiveness of the bid to the guarantee requirement.").



specifically with the first, preaward scenario, in which the government was required to award to the next lowest bidder, regardless of the lowest bidder's ability to obtain legitimate bonding at a later time.<sup>361</sup> Conversely, in Stern the court addressed the second, post-award scenario in which the government could have-but did not-reprocure the contract, instead electing to award to the next lowest offeror within the same procurement action.<sup>362</sup>

However, the concerns articulated in Stern could easily be applied to preaward situations. Should the defendant be held accountable for the difference in bid prices when no evidence exists to suggest that the lowest bidder was capable of obtaining legitimate bonding? To the extent Stern would require the government to present other corporate or individual sureties to testify that if the lowest offeror had sought bonding, it would have provided it, the court invites speculation and places an unwarranted burden on the government. Rather than create such a rebuttable presumption out of whole cloth, the tack taken by the court in Hunt appears to better comport with the guidelines and its interpretive caselaw.

Support for the Hunt approach may be found in the analogous field of insurance fraud. Analogies are frequently drawn between

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<sup>361</sup> Hunt, Sentencing Transcript at 37 (bid bonds).

<sup>362</sup> Stern, 13 F.3d at 492 (awarded contract prior to fraud being discovered).

surety bonds and insurance.<sup>363</sup> As with surety bonds, insurance is purchased as a means of protection against certain risks. In cases where the defendant sold insurance policies that were unsupported by adequate assets, the courts have not required the government to prove that the victims were capable of purchasing insurance from a legitimate insurance company.

For example, in United States v. Neadle,<sup>364</sup> the defendant fraudulently obtained an insurance license by falsely reporting that his insurance company's initial capital, certificates of deposit, were unencumbered.<sup>365</sup> Applying § 2F1.1 at sentencing, the court determined that the loss to the policy holder/victims was \$20,438,748, the difference between the policy holders' insurance claims (\$24,438,748) and the defendant's company's

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<sup>363</sup> See e.g. Commonwealth v. Edwards, 582 A.2d 1078, 1090 (Pa. Super. Ct. 1990) ("A performance bond is a type of insurance . . . ."), cert. denied, 600 A.2d 1258 (Pa. 1991); see also United States ex rel. Ehmcke Sheet Metal v. Wausau Insur. Co., 755 F. Supp. 906, 913 (E.D. Cal. 1991) (although possessing a "distinct legal history" "suretyship is sometimes treated as a form of insurance . . . ."); A.W. And Assoc., B-239740, 90-2 CPD ¶ 254, at 3 ("surety companies are generally considered to be similar to insurance companies . . . ."); Sureties' Obligations: The Duty To Deal In Good Faith, 3 N&CR ¶ 55 (Aug. 1989) (While "suretyship is not the same as insurance . . . . the surety performs many functions that are similar to the function served by an insurer."); John R. Emshwiller, Subcontractors Sue To Get Paid For Federal Jobs, Wall St. J., Dec. 28, 1988, 1988 WL-WSJ 430289 ("The government does require a general contractor to put what's known as a surety bond, a sort of insurance policy that is supposed to guarantee work will be paid for.").

<sup>364</sup> 72 F.3d 1104 (3rd Cir. 1995), amended, 79 F.3d 14 (3rd Cir.), cert. denied, 117 S.Ct. 238 (1996).

<sup>365</sup> Id. at 1106.

reinsurance (\$4 million).<sup>366</sup> The government was not required to establish that the policy holders were capable of obtaining insurance elsewhere. Indeed, the Third Circuit's majority opinion affirming the district court's loss determination specifically rejected that argument, despite acknowledging the existence of a "tight" insurance market.<sup>367</sup>

Similarly, in United States v. Sandlow,<sup>368</sup> the defendant and his co-defendants established several insurance companies that received health insurance premiums despite failing to provide any insurance.<sup>369</sup> Determining loss pursuant to § 2F1.1, the court included the amount of premiums paid to the defendants for the nonexistent insurance and all outstanding insurance claims.<sup>370</sup> No

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<sup>366</sup> Id. at 1108. The large amount of claims represented damage caused by Hurricane Hugo. Id. at 1107. Interestingly, the defendant argued for a lower loss calculation, drawing an analogy between himself and a contractor who obtains the contract by fraudulent means but otherwise is prepared to perform properly. Id. at 1109.

<sup>367</sup> "The dissent implies that the individuals, who purchased policies from [the defendant's insurance company], could not have purchased insurance coverage from any other source and for that reason did not suffer any loss from the damage done by Hurricane Hugo which they would not otherwise have suffered. However, despite the tightness of the insurance market in the Virgin Islands, the record before us does not support the supposition, and Neadle does not claim, that there was no insurance coverage available in the Virgin Islands market for the . . . policy holders." Id. at 1109 n.5.

<sup>368</sup> 78 F.3d 388 (8th Cir. 1996).

<sup>369</sup> Id. at 390.

<sup>370</sup> Id. at 392; see also United States v. Allen, 75 F.3d 439, 442 (8th Cir. 1996) (loss includes premiums paid for insurance not deceived and amount of outstanding insurance claims) ..

requirement was imposed on the government to establish that the defrauded policy holders were capable of obtaining insurance elsewhere.<sup>371</sup>

Finally, in United States v. Bonano,<sup>372</sup> the defendants conspired to sell automobile insurance policies that "were literally not worth the paper they were printed on, as they had nothing to back them up."<sup>373</sup> The defendants accepted all policy applications without bothering to investigate their customers' driving record.<sup>374</sup> Eventually, 877 customers purchased insurance policies, agreeing to pay \$622,140 in premiums, albeit the defendants only collected \$176,561.56 before their fraudulent scheme was closed down.<sup>375</sup> The United States Court of Appeals for the Seventh Circuit affirmed the district court's determination that, pursuant to § 2F1.1, the defendants' intended loss for purposes of sentencing was \$622,140.<sup>376</sup> Noticeably absent from the Seventh Circuit's opinion was any requirement that the government prove all 877 policy holders would have been able to

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<sup>371</sup> Significantly, the court included in its calculation of loss all premiums paid for the nonexistent insurance, whether or not the policy holders actually made a claim on their policies. By analogy, premiums paid for worthless bonds should be included within the defendant's loss calculation whether or not a bonded contractor goes into default.

<sup>372</sup> \_\_\_\_ F.3d \_\_\_\_ (7th Cir. 1998), 1998 WL 309085.

<sup>373</sup> 1998 WL 309085, at \*2.

<sup>374</sup> Id.

<sup>375</sup> Id. at 4.

<sup>376</sup> Id. at \*7.

obtain auto insurance elsewhere had they not obtained it from the defendants.

Notwithstanding that the decision in Stern appears to be wrongly decided, to the extent some limitations should be placed on this particular method of loss calculation, guidance may be gleaned from CDA caselaw dealing with the reasonableness of reprocurement costs. Rather than requiring the government to prove the lowest bidder's ability to perform the work and/or to obtain legitimate bonding, a sentencing court may limit itself to examining the reasonableness of the government's reprocurement conduct and associated costs.

Under the CDA, the government must show that it acted reasonably and timely under the circumstances to mitigate its damages.<sup>377</sup> Specifically, to recover excess reprocurement costs after terminating the original contract for default the government must prove:

that the reprocured contract work was the same as or similar to the terminated work; it reprocured within a reasonable time after the default termination; the reprocurement price was reasonable and [the government] reasonably mitigated damages; it made final payment on the reprocurement contract; and the excess costs assessed are based on [the government's] liability for a sum certain.<sup>378</sup>

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<sup>377</sup> Pronto Aire Panama, S.A., ENG BCA Nos. PCC-102 & 123, 96-2 BCA ¶ 28, 538, at 142,488 (citations omitted); see also American Kal Enterprises, GSBCE No. 4987, 80-2 BCA ¶ 14,522, at 71,567 ("We find that in its reprocurement efforts the government obtained fair and reasonable prices and properly exercised its duty to mitigate the damages chargeable to [the contractor].").

<sup>378</sup> Arctic Corner, Inc., ASBCA No. 38075, 94-1 BCA ¶ 26,317, at 130,903; see also Pronto Aire Panama, S.A., ENG BCA Nos. PCC-

These requirements protect "the contractor's pocket . . . from the consequences of an extravagant or improper reprocurement."<sup>379</sup>

Rather than require a second round of bids if the government cannot establish that the lowest bidder was capable of obtaining legitimate bonding and offering the same low bid, as the court in Stern suggests, a court need only determine if the government's election to award the contract to one of the original bidders, and the ultimate contract price, was reasonable under the circumstances.<sup>380</sup> At the preaward stage of a procurement, when the government must award to the next lowest responsive, responsible bidder, a court need only make inquiry into the reasonableness of the ultimate contract price.

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102 & 123, 96-2 BCA ¶ 25, 538, at 142,488. The government must satisfy its burden by a preponderance of the evidence. Givens Services, DOT BCA No. 2907, 96-2 BCA ¶ 28,271, at 141,170.

<sup>379</sup> Marley v. United States, 423 F.2d 324, 333 (Ct. Cl. 1970)

<sup>380</sup> See e.g. M.A.W. Co., AGBCA Nos. 95-226-1, 96-185-1, 97-1 BCA ¶ 28,759, at 143,527 (because of time constraints associated with unpredictable weather, the government's decision to solicit bids from the three lowest bidders on the original contract was reasonable); Pronto Aire Panama, S.A., ENG BCA Nos. PCC-102 & 123, 96-2 BCA ¶ 25, 538, at 142,488 (decision to award contract to next lowest, original bidder was reasonable); accord Hellenic Corp., ASBCA No. 29210, 86-2 BCA ¶ 18,974 (test of reasonableness). Although the government would bear the ultimate burden of proof, the defendant would be required to at least establish a prima facie case that the government had acted unreasonably or had otherwise failed to meet its contractual obligations, before the matter would be placed at issue. See Pronto Aire Panama, S.A., ENG BCA Nos. PCC-102 & 123, 96-2 BCA ¶ 25,538, at 142,488.

Finally, albeit the reasoning of Schneider serves to reduce the guidelines exposure of an otherwise legitimate contractor who obtains a contract award through the use of fraudulent bonds, the case provides little relief to the individual surety or surety broker who knowingly provides fraudulent bonds. The court's reasoning in Schneider was based on the premise that the defendant intended to perform and therefore fell into the less egregious fraud category.<sup>381</sup> However, Schneider is easily distinguished when the surety, or surety broker, is either knowingly unable or intentionally unwilling to honor its commitments under the surety bond. Under these circumstances the defendant would fall into Judge Possner's initial fraud category and the higher loss calculation would apply.

#### 4. Relevant Conduct

As mentioned in the earlier discussion of the Hunt case, the federal sentencing guidelines permit the inclusion in the loss calculation of all "conduct relevant to the count of conviction."<sup>382</sup> Section 1B1.3 defines relevant conduct broadly to

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<sup>381</sup> Schneider, 930 F.2d at 558 ("means to perform the contract (and is able to do so) . . . .") & 559 (discussing United States v. Johnson, 908 F.2d 396 (8th Cir. 1990)); see United States v. Wolfe, 71 F.3d 611, 618-9 (6th Cir. 1995) (reasoning of Schneider applies only where contractor both intended to render services and it was possible for the contractor "to have performed the contract to the government's satisfaction.") .

<sup>382</sup> United States v. Heath, 122 F.3d 682, 684 (8th Cir.), cert. denied, 118 S.Ct. 431 (1997) .

include all acts or omissions that the defendant encouraged, caused or assisted;<sup>383</sup> common scheme conduct;<sup>384</sup> and any harm resulting from such conduct.<sup>385</sup> To increase the defendant's offense level, relevant conduct need only be proven by a preponderance of the evidence.<sup>386</sup>

Relevant conduct cognizable under the guidelines includes acts or omissions falling outside the applicable statute of limitations<sup>387</sup> and-as illustrated by the Hunt case-uncharged misconduct.<sup>388</sup> In United States v. Watts,<sup>389</sup> the United States Supreme Court held that acquitted conduct, if proved by a preponderance of the evidence, may be included as relevant conduct for purposes of sentencing.

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<sup>383</sup> U.S.S.G. § 1B1.3(a)(1)(A) ("all acts and omissions committed, aided, abetted, counseled, commanded, induced, procured, or willfully caused by the defendant; . . . .")

<sup>384</sup> U.S.S.G. § 1B1.3(a)(1)(B) ("in the case of a jointly undertaken criminal activity (a criminal plan, scheme, endeavor, or enterprise undertaken by the defendant in concert with others, whether or not charged as a conspiracy), all reasonably foreseeable acts and omissions of others in furtherance of the jointly undertaken criminal activity, . . . .").

<sup>385</sup> U.S.S.G. § 1B1.3(a)(3) ("all harm that resulted from the acts and omissions specified in subsections [1B1.3] (a)(1) and (a)(2) . . . and all harm that was the object of such acts and omissions . . . .").

<sup>386</sup> United States v. Zagari, 111 F.3d 307, 323 (2d Cir. 1997).

<sup>387</sup> United States v. Matthews, 116 F.3d 305, 307 (7th Cir. 1997) (noting that six other circuits had ruled similarly).

<sup>388</sup> Id.

<sup>389</sup> 117 S.Ct. 633 (1997).



Albeit embracing a liberal standard of inclusion, the guidelines impose some limitations. First, the relevant conduct "must be criminal conduct."<sup>390</sup> Further, for common scheme conduct to be included the defendant's acts must "be substantially connected to each other by at least one common factor, such as common victims, common accomplices, common purpose, or similar modus operandi."<sup>391</sup>

Significantly, losses included under the relevant conduct umbrella in surety bond fraud cases are not limited to those damages suffered by victims of fraudulent **federal** surety bonds. In United States v. Bickmore,<sup>392</sup> the defendant was convicted of mail and wire fraud, making counterfeit bonds, and providing false statements on federal surety bonds.<sup>393</sup> On appeal, Bickmore challenged the inclusion in his guideline calculation of a loss suffered by a school district that resulted from a fraudulent non-federal bond.<sup>394</sup> Rejecting the challenge, the court posited "that conduct that does not violate federal law but is part of a

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<sup>390</sup> United States v. Dickler, 64 F.3d 818, 830 (3rd Cir. 1995) (citations omitted).

<sup>391</sup> U.S.S.G. § 1B1.3, cmt. (n.9(A)); see also United States v. Matthews, 116 F.3d 305, 306 (7th Cir. 1997).

<sup>392</sup> 988 F.2d 122 (9th Cir. 1993) (Table), 1993 WL 69158.

<sup>393</sup> Id. at \*1.

<sup>394</sup> Id.

common scheme as a federal crime is 'relevant conduct'" for guideline purposes.<sup>395</sup>

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<sup>395</sup> Id. (citing United States v. Newbert, 952 F.2d 281, 284 (9th Cir. 1991), cert. denied, 112 S.Ct. 1702 (1992)).

## VI. IMPACT OF ELECTRONIC CONTRACTING

A potential legal storm cloud looming on the horizon is the use of electronically provided individual surety bonds. In 1994, the Federal Acquisition Streamlining Act (FASA)<sup>396</sup> required the government to increase use of electronic commerce and electronic data interchange as part of the federal procurement process.<sup>397</sup> As a direct result of FASA, the Federal Acquisition Computer Network (FACNET) was created.<sup>398</sup> Significantly, one of FACNET's purposes was to "[p]ermit [the] electronic submission of bids and proposals . . . ."<sup>399</sup> However, numerous problems plagued FACNET

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<sup>396</sup> Pub.L.No. 103-355, 108 Stat. 3243 (1994).

<sup>397</sup> Scott N. Godes, Government Contracting On The Internet: Abandoning FACNET As The Government's Network For Electronic Commerce, 26 Pub. Con. L. J. 663 (1997); see also Major Andy K. Hughes, Simplified Acquisitions And Electronic Commerce: Where Do We Go From Here?, Army Law., Jun. 1995, at 38 (FASA required "federal agencies to develop an interconnected computer system that eventually will allow agencies to perform contracting procedures electronically.").

Electronic Commerce refers to "the paperless exchange of business information using Electronic Data Interchange (EDI), Electronic Mail (E-Mail), computer bulletin boards, FAX, Electronic Funds Transfer (EFT), and other similar technologies." Introduction To Department of Defense Electronic Commerce: A Handbook For Business, U.S. Department of Defense 3 (Version 2, 1996) [Hereinafter "EC Handbook"]. Electronic Data Interchange is defined as "the computer-to-computer exchange of business information using a public standard." Id.

<sup>398</sup> Hughes, supra note 397, at 42 (citing FASA § 9001). FACNET "means the Government-wide Electronic Commerce/Electronic Data Interchange (EC/EDI) operational capability for the acquisition of supplies and services that provides for electronic data interchange of acquisition information between the Government and the private sector, employs nationally and internationally recognized data formats, and provides universal user access." FAR 2.101.

<sup>399</sup> EC Handbook, supra note 397, at 11.

from its inception,<sup>400</sup> hampering its utility as a forum for electronic commerce<sup>401</sup> and causing many in the federal procurement community to favor the Internet as the primary means of electronic commerce.<sup>402</sup>

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<sup>400</sup> Raymond S.E. Pushkar, Ian T. Graham, and Arleigh V. Closser, Electronic Commerce & Contracting, Contract Management 13, 15 (Dec. 1997) (network delivery problems prevented contractor bids from timely reaching the contracting officer); see also Godes, supra note 397, at 669 (problems in implementation and use, high costs of Value Added Networks (VAN), and "technological difficulties exist[ing] in the operation and maintenance of FACNET."); see Ross W. Bransletter, Acquisition Reform: All Sail And No Rudder, Army Law., March 1998, at 3, 6 (FACNET "has been a 'failure' . . . . [t]hose actions which were conducted using FACNET were slower, more expensive, and less reliable than processing them using the old, pre-reform methods.").

<sup>401</sup> Pushkar, Et Al., supra note 400, at 14 ("Although the federal government has launched a full-scale effort to conduct EC through FACNET, the cost and problems with the infrastructure have severely inhibited its acceptance throughout the procurement community."); see Godes, supra note 397, at 669 (As a result of the "enormous difficulties implementing FACNET" . . . "many contractors and government agencies have refused to use (or rely solely upon) the system.").

<sup>402</sup> Pushkar, Et Al., supra note 400, at 14 ("Significantly, several agencies including the National Aeronautics and Space Administration, the Air Force, and the Army indicated to GAO that they intend to focus their EC efforts on Internet-based acquisition services and not FACNET."); cf. Godes, supra note 397, at 664 (Government should abandon FACNET and rely upon the Internet). In light of the preference for the Internet voiced by some military agencies, it is interesting to note that the Internet was originally an outgrowth of the military's ARPANET program, which was established to create a computer system permitting communication between the military, defense contractors and those universities conducting military research through the use of redundant channels in the event that portions of the computer network suffered war-related damage. Benjamin Wright and Jane K. Winn, The Law of Electronic Commerce § 2.06, 2-2 (3rd ed., 1998).

In 1998 Congress repealed the requirement to use FACNET for government electronic procurements. National Defense Authorization Act For Fiscal Year 1998, § 850, Pub. L. No. 105-85, 111 Stat. 1629.

Despite the federal government's rush to paperless contracts, the law has failed to keep pace with the technological advances.<sup>403</sup> Indeed, although permitting electronic bids under some circumstances,<sup>404</sup> the FAR has not addressed if or how individual surety bonds will be used in electronic procurements. Further, with one limited exception,<sup>405</sup> no policy appears to exist in any federal agency that addresses the electronic filing of surety bonds generally or individual surety bonds in particular.<sup>406</sup>

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<sup>403</sup> Pushkar, Et Al., supra note 400, at 15 ("The continuing technological advances have fundamentally outstripped the ability of the legal system to keep pace.").

<sup>404</sup> "Bids submitted by electronic commerce shall be considered only if the electronic commerce method was specifically stipulated or permitted by the solicitation." FAR 14.301(e).

<sup>405</sup> The Federal Highway Administration, Department of Transportation, permits the electronic filing of surety bonds for motor carriers and property brokers. 49 C.F.R. § 387.323. Functioning like a performance bond, the surety bond is a \$10,000 fixed penalty bond that is used when a property broker fails to fulfill its obligation to a motor carrier shipper. Telephone Interview with Patricia Burke, Federal Highway Administration, July 6, 1998. Each insurer must first preregister and receive an individual account number and computer password. 49 C.F.R. § 387.323(b). Further, the insurer must agree, upon request, to provide a duplicate original of any surety bond or other filing. 49 C.F.R. § 387.323(d). Significantly, the electronic filing of surety bonds is limited to licensed insurance companies or similar financial institutions. Burke Interview, supra. The electronic filing authorization is not applicable to individual surety bonds. Id.

<sup>406</sup> Telephone interview with Bruce Propert, Department of Defense Electronic Commerce Information Center, February 6, 1998 (DoD has published no policy directly related to the question.); Telephone Interview with Walt Norko, Construction Division, Army Corps of Engineers, February 11, 1998 (The Corps has not addressed that issue.); Telephone Interview with Edward Loeb, Office of Federal Acquisition Policy, General Services

One issue in this area deals with the requirement for signatures. As a general rule, a contractor's bid must be signed or it will be rejected as nonresponsive.<sup>407</sup> Failure to sign may be waived as a minor informality only if the bid is accompanied by other documentation evidencing an intent to be bound.<sup>408</sup>

The signature, or equivalent, requirement applies with equal force to documents supporting an individual surety bond. Surety bonds presented to the government in other than their original form have been rejected as facially defective. Facsimile copies of bid bonds are generally unacceptable "because there is no way for the contracting agency to be certain from examining a copy-- other than by referring to the original after bid opening-- whether the original has been altered without the surety's knowledge or consent."<sup>409</sup> Likewise, photocopies of bid guarantee

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Administration, July 13, 1998 (No mechanism for doing it yet).

<sup>407</sup> Micon Corp., B-249231, 92-2 CPD ¶ 293, at 2 ("In general, a bid which is not signed must be rejected as nonresponsive because, without an appropriate signature, the bidder would not be bound upon the government's acceptance of the bid."); see also Fifth Const. Co. v. United States, 36 Fed. Cl. 268, 272 (1996).

<sup>408</sup> Micon Corp., B-249231, 92-2 CPD ¶ 293, at 2 ("such a waiver is proper where the bid was accompanied by other material--such as a signed bid guarantee that refers to and clearly identifies the bid--indicating the bidder's intention to be bound."); see also Regional Trucking, PSBCA No. 3918, 97-1 BCA ¶ 28,733; FAR 14.405(c)(1).

<sup>409</sup> R.P. Richards, B-272430, 96-2 CPD ¶ 138, at 2; see also Frank and Son Paving, B-272179, 96-2 CPD ¶ 106, at 2.

documents have caused the corresponding bid to be rejected as nonresponsive.<sup>410</sup>

In an effort to permit EDI transmissions to legally bind the parties, the FAR definition of a signature was modified to include electronic symbols.<sup>411</sup> Further, in National Institute of Standards and Technology,<sup>412</sup> the Comptroller General determined that message authentication codes and digital signatures that adhere to federal standards are the electronic equivalent of signatures.<sup>413</sup> Accordingly, under the proper circumstances, the federal government will recognize the legal validity of

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<sup>410</sup> Morrison Const. Serv., B-266233, 96-1 CPD ¶ 26; see also Frank and Son Paving, B-272179, 96-2 CPD ¶ 106, at 2.

<sup>411</sup> FAR 2.101 ("signature" includes verifiable symbols from electronic systems). But cf. Cox, supra note 1, at 10 (The FAR's failure to require verification of electronic signatures is a systemic weakness that increases the government's susceptibility to fraud).

<sup>412</sup> B-245714, 96-2 CPD ¶ 225.

<sup>413</sup> Id. at 3 ("We conclude that EDI systems using message authentication codes which follow NIST's Computer Data Authentication Standard (Federal Information Processing Standard (FIPS) 113) or digital signatures following NIST's Digital Signature Standard . . . can produce a form of evidence that is acceptable . . . ."); see also John Cibinic, Jr. and Ralph C. Nash, Jr., Formation of Government Contracts 244 (3rd ed. 1998) ("The Comptroller General has concluded that EDI technology offers evidence of an intent to be bound that has the same attributes as a handwritten signature.") (citing National Inst. of Standards & Technology); Major Anthony M. Helm, Et Al., 1991 Contract Law Developments, Army Law., Feb. 1992, at 12 ("Electronic 'message identification codes' that conform to Federal Information Processing Standard 113 are the functional equivalent of handwritten signatures."); cf. Pushkar, Et Al., supra note 400, at 16 ("Digital signatures further satisfy formal legal requirements of form, such as 'writing,' 'signature,' and an 'original document.'").

electronic contracts in general, and electronic signatures in particular.<sup>414</sup>

Digital signatures in particular have been touted as a relatively inexpensive, practical, and verifiable method of conducting electronic commerce,<sup>415</sup> which theoretically could be used for electronic surety bonds. These electronic signatures are made possible by encryption technology, which encodes not only the electronic message, but also the digital signature.<sup>416</sup>

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<sup>414</sup> See Helm, supra note 413, at 12 ("paperless contracts are legally sufficient, as long as agencies safeguard electronic files to prevent unauthorized alterations and use appropriate message identification codes to ensure that only contracting officers actually authenticate contracts."); EC Handbook, supra note 263, at 55 ("It has been determined that contracts entered into electronically with the Federal Government by using EDI are valid, enforceable contracts in the same manner as documents signed on paper."); cf. Federal Acquisition Regulation: Electronic Contracting, 58 Fed. Reg. 69588 (proposed Dec. 30, 1993) ("The proposed rule will clarify that electronic data interchange may be used, if authorized by the contracting officer, to accomplish and contracting action . . . . [and] incorporates a General Accounting Office Advisory Opinion (B-238449) which confirms that EDI transactions can create legally binding obligations in accordance with 31 U.S.C. 1051).

<sup>415</sup> Pushkar, Et Al., supra note 400, at 16 (Digital signatures "permit the recipient of an electronic communication to verify its integrity . . . . [and] "permit contract formation over nonsecure but inexpensive and widely used networks."); cf. David M. Nadler and Kendrick C. Fong, Businesses And Consumers Prepare For Electronic Contracting, Wash. Tech., Aug. 28, 1997, at 20 ("Anyone can pay to receive a private key by submission of an e-mail address and user name to certifying companies.").

<sup>416</sup> Glen-Peter Ahlers, Sr., The Impact Of Technology On The Notary Process, 31 J. Marshall L. Rev. 911, 918 (1998). But cf. E.C. Handbook, supra note 397, at 9 ("Such encryption technology is new, and currently is not widely used.").



Digital signatures rely on a private/public key system.<sup>417</sup> The document signer uses the private key to create the signature, and the document's recipient uses the public key "to verify the signature and authenticate the document."<sup>418</sup> Algorithms are used to create unique signatures and to ensure that the document has not been altered after it has been signed.<sup>419</sup> Although an electronic message can be intercepted, it cannot be decoded without using the correct key.<sup>420</sup>

Generally, digital signatures cannot be forged unless the private key is stolen or a third party gains access to it and uses it in an unauthorized manner.<sup>421</sup> To further ensure the authenticity of digital signatures initiatives are underway to create "cybernotories."<sup>422</sup> These individuals would act as a

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<sup>417</sup> Nadler & Fong, supra note 415, at 20, col. 2.

<sup>418</sup> Id. "In executing an electronic or digital 'signature,' special software 'reads' a document and 'signs' it with a string of electronic numbers known only to the person signing the document. When the document is received, corresponding software 'reads' the signature and verifies its authenticity." Ahlers, supra note 416, at 918 n.37.

<sup>419</sup> Ahlers, supra note 416, at 916.

<sup>420</sup> Id. at 918 ("While the digital message might be intercepted by others, only someone holding the correct key can unwrap the signature package to verify the signor, unwrap the encoded message, and verify that the contents of the original package have not been tampered with since being sent into the electronic stream.").

<sup>421</sup> Nadler & Fong, supra note 415, at 20; see also Ahlers, supra note 416, at 919 ("The digital signature cannot be forged, unless the signer loses control of the private key . . .").

<sup>422</sup> However, "the CyberNotory concept combines a novel legal specialization that does not currently exist with a technical competency that is also unheard of . . . ." Ahlers, supra note

depository for both private and public keys, and would verify that a specific key belonged to a particular person or entity.<sup>423</sup>

However, in the context of the individual surety bond program, it is reasonable to expect that many individual sureties will not personally submit an electronic version of the Affidavit of Individual Surety with every bid, performance and payment bond. Realistically, if the federal government requires that individual surety bonds be electronically transmitted, individual sureties will gravitate toward surety brokers, or a similar type of intermediary, possessing the capability of making electronic transmissions on the sureties' behalf. First, many unsophisticated individual sureties may not even own a computer or reasonably have access to one capable of independently transmitting an electronic surety bond to the government. Second, the expense and inconvenience associated with requiring individual sureties to acquire the computer equipment necessary to participate in electronic commerce may either eliminate a large portion of the potential surety pool from the program or funnel sureties toward brokers, who will handle all transactions of their behalf for a fee.

Under this scenario, many of the circumstances giving rise to earlier abuses of the individual surety program could then arise. If, as is likely, individual sureties turn over their private key to a broker, sureties will effectively be performing

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416, at 912.

<sup>423</sup> Id. at 919.

the functional equivalent of signing blank bond documents to be used as the broker elects. Fraudulent brokers may post the surety's land as collateral for individual surety bonds without notifying the surety. In the event of contractor default, sureties may claim that the broker's use of its digital signature was unauthorized and refuse to meet their obligations under the bond.

Additionally, the anonymity associated with electronic commerce will make it more difficult to target a specific individual for prosecution when fraudulent surety bonds are submitted to the government.<sup>424</sup> This difficulty will be particularly pronounced if electronic documents authored by several different authors -- sureties, appraisers, underwriters, cybernotaries, etc. -- are centralized and transmitted from a single broker's computer system. Unlike a handwritten signature, whose ownership may be established through the testimony of experts and those familiar with the signature, digital signatures may be created by anyone at a computer keyboard with access to the private key.

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<sup>424</sup> "The most difficult problem facing lawmakers and users of digital signatures is to assure that the party who distributes a public key is who he says he is. Paper signatures have an intrinsic association with a particular person because they are made in the signer's unique handwriting. However, a private key used to create signatures has no intrinsic association with a particular individual." Nadler & Fong, supra note 415, at 20, col. 3. But cf. United States v. Shah, 44 F.3d 285, 295 (5th Cir. 1995) (For a false statement conviction, pursuant to 18 U.S.C. § 1001, "[t]he government need not make a case for identity air-tight; identity may be inferred circumstantially . . .").

A potential, but legally unsatisfactory, solution to the electronic submission problem would be to require the broker to forward the original, signed copy of all surety bond documentation or to maintain such documentation on the broker's premises for government inspection. However, this method of electronic transmission of surety bonds directly conflicts with the sealed bidding system's mandate that responsiveness be determined at the time of bid opening, based solely upon the bid documents presented at that time.<sup>425</sup> Under existing law, it would be improper for the contracting officer to consider hard copy bond documents after bid opening for the purpose of verifying electronically filed documents.<sup>426</sup>

Clearly, many unresolved questions remain about electronic commerce in general and the use of electronically transmitted surety bonds in particular. However, when determining if and how individual surety bonds play a role in electronic commerce, the FAR will be required to address the same, or similar, regulatory shortcomings that has made the individual surety bond program susceptible to fraud in the "paper" contract context.

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<sup>425</sup> A.W. And Assoc., B-239740, 90-2 CPD ¶ 254, at 2 ("the responsiveness of a bid must be determined solely from the bid documents . . . ."); see also Firth Const. Co. v. United States, 36 Fed. Cl. 268, 275 (1996) ("Responsiveness . . . is determined at the time of bid opening. Accordingly, a bid that is non-responsive on opening may not be made responsive by subsequent submissions or communications.").

<sup>426</sup> See Morrison Const. Serv., B-266233, 96-1 CPD ¶ 26, at 4 ("it would have been improper for the agency to have considered the late bid documents for the purposes of confirming the accuracy of the photocopied ones . . . .").

Additionally, many of the same reasons that cry out for increased regulation of individual surety bond brokers in nonelectronic procurement, apply equally to electronic acquisitions.

## VII. CONCLUSION

The individual surety bond program serves an important function in the federal acquisition system by making surety bonds available to small contractors who would normally be precluded from contract competition. However, despite improvements in FAR coverage since 1990, the program remains susceptible to fraud and increased preventive measures are required. Much of this susceptibility can be eliminated by relatively inexpensive disclosure and verification requirements.

First, the FAR must regulate individual surety bond brokers. Any person or entity who has been suspended, debarred or proposed for debarment, or who has suffered a felony conviction within the reach of 18 U.S.C. § 2408, should not be permitted to serve as a surety broker during the specified period of ineligibility. To identify brokers, and sureties, ineligible to participate in federal acquisition, the FAR should require a certification from the contractor, surety broker and/or individual surety stating that to the best of the person's knowledge no individual with a financial interest in the bond is operating under one of the enumerated legal prohibitions.

Second, FAR Part 28 must be modified to protect the integrity of the individual surety bond program. To eliminate

unnecessary confusion, the term "fee simple" should be changed to "fee simple absolute." Additionally, when land is pledged as collateral for bonds, both a current appraisal and the most recent tax assessment should be provided to the contracting officer. Requiring both documents will improve the contracting officer's ability to verify the land's ownership and value. Regardless of the requirements of the Uniform Standards of Appraisal Practice, the FAR should require that any appraisal submitted in support of an individual surety bond reflect that the appraiser actually visited the land at issue and verified ownership by examining local records. Any chain of title relying upon a quit claim deed should be per se inadequate and cause for rejection.

Finally, to the extent criminal sanctions exist to either deter misconduct in the individual surety bond program or to punish such misconduct when it is discovered, the applicable criminal statutes and sentencing provisions remain largely unused or unclear in their application. If the integrity of the federal procurement system is to be adequately protected by the criminal system, then existing criminal provisions of the law should be expanded or aggressively applied, as applicable. The scope of 18 U.S.C. § 2408 should be expanded beyond DoD to include all federal agencies, reach any acquisition above the simplified acquisition threshold, and the criminal penalty should extend to contractors who knowingly use a § 2408 felon as a surety or surety broker.



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